INDUSTRY COMMISSION

IMPLICATIONS FOR AUSTRALIA OF FIRMS LOCATING OFFSHORE

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Forming the Productivity Commission

The Commonwealth Government, as part of its broader microeconomic reform agenda, is merging the Bureau of Industry Economics, the Economic Planning Advisory Commission and the Industry Commission to form the Productivity Commission. The three agencies are now co-located in the Treasurer's portfolio and amalgamation has begun on an administrative basis.

While appropriate arrangements are being finalised, the work program of each of the agencies will continue. The relevant legislation will be introduced soon. This report has been produced by the Industry Commission.

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Forming the
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Commission

28 August 1996

The Honourable Peter Costello MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with Section 7 of the *Industry Commission Act 1989*, we have pleasure in submitting to you the Commission's final report on Implications for Australia of Firms Locating Offshore.

Yours sincerely

Gary Banks
Presiding Commissioner

John Cosgrove
Commissioner

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MAIN ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACM	Australian Chamber of Manufactures
ADIA	Australian direct investment abroad
APEC	Asia-Pacific Economic Cooperation
ATSIC	Aboriginal and Torres Strait Islander Commission
ATO	Australian Tax Office
BIE	Bureau of Industry Economics
CEN	capital export neutrality
CEPA	Commonwealth Environment Protection Agency
CIN	capital import neutrality
DFAT	Department of Foreign Affairs and Trade
EAAU	East Asia Analytical Unit
FDI	foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
MTIA	Metal Trades Industry Association
NN	national neutrality
NNTT	National Native Title Tribunal
NTA	Native Title Act
OECD	Organisation for Economic Co-operation and Development
R&D	research and development
RDA	Racial Discrimination Act
UN	United Nations
WIRA	Waterfront Industry Reform Authority
WTO	World Trade Organization

TERMS OF REFERENCE

IMPLICATIONS FOR AUSTRALIA OF FIRMS LOCATING OFFSHORE

I, GEORGE GEAR, Assistant Treasurer, under Part 2 of the Industry Commission Act 1989:

1. refer the question of firms in Australia locating part or all of their operations offshore for inquiry and report within twelve months of receiving this reference;
2. specify that in making its recommendations the Commission aim to improve the overall economic performance of the Australian economy;
3. request that the Commission report on the key factors affecting the decisions of firms to locate offshore; in particular that the Commission report on any institutional, regulatory or other arrangements subject to influence by government in Australia or overseas, which lead to inefficiencies in location decisions and advise on courses of action to remove or reduce those inefficiencies;
4. specify that the Commission report on the implications of offshore location decisions for Australia in the short and long term, paying particular attention to:
   (a) employment levels and composition;
   (b) national income;
   (c) net export performance;
   (d) taxation and the treatment of repatriated profits; and
   (e) changes in the size and composition of Australia's industry base.
5. request that the Commission report on:
   (a) the short and long term costs and benefits to Australia arising from offshore location decisions;
   (b) the effect of firms locating offshore on Australia's economic and other links with other countries;
   (c) those policies that might serve to enhance domestic skilled employment, value adding activities and production;
   (d) without disclosing material provided in confidence, examples of past successes or failures of firms locating offshore, by way of case studies or other means; and
   (e) implementation strategies for any measures recommended by the Commission;
6. specify that the Commission:
   (a) take account of any recent substantive studies undertaken elsewhere, including "Outward Investment by Australian companies" by the Bureau of Industry Economics; and
   (b) have regard to established economic, social and environmental objectives of governments.

GEORGE GEAR

31 AUGUST 1995

SUMMARY

This report deals with the reasons for, and the economic implications of, decisions by firms in Australia to locate operations offshore. The inquiry arose in the context of relatively rapid growth in offshore investment. While such investment provides opportunities for Australian firms to achieve increased competitiveness and expansion through closer integration into the world economy, there is debate about whether it detracts from domestic employment, exports and economic growth.

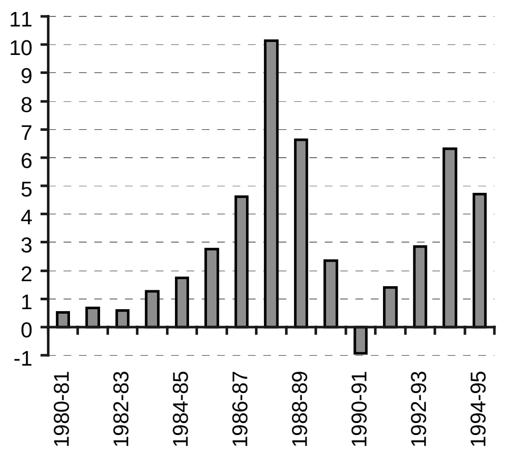
Only Australian *direct* investment abroad (ADIA) is covered by the inquiry — that is, investment by Australian firms which provides them with significant influence over the operations of a foreign enterprise. Portfolio investment — which comprises the bulk of Australian overseas investment — is outside the inquiry's terms of reference.

Nature and extent of ADIA

Fuelled by the liberalisation of financial markets in Australia and in many other economies, and by an international trend to relax restrictions on inward capital flows, ADIA has increased greatly since the early 1980s (see Figure 1). This trend is not unique to Australia — it is consistent with a global surge in foreign direct investment over the last decade.

In the three years to 1994–95, average annual ADIA was $4.6 billion — equivalent to around 1.1 per cent of GDP and 11 per cent of private domestic investment. Direct investment by foreigners in Australia remains significantly higher than ADIA, although the gap is closing.

Figure 1: **Outflows of ADIA**
($ billion, current prices)



The total value of the stock of ADIA stood at nearly $53 billion in 1994–95. Relative to the size of the economy, this is not high by international standards. Significantly, around 80 per cent is in English-speaking countries — namely, the United Kingdom, the United States and New Zealand. Around half is invested in service sector activities.

Why do firms invest

offshore?

Previous studies, survey data and information gathered by this inquiry all confirm that market demand-related influences provide the major impetus for most offshore investment decisions in sectors other than mining (where access to natural resources is usually the main influence). The dominant market demand-related factor is higher growth opportunities in host markets. Many overseas countries have markets far larger than the Australian market, and some are experiencing high rates of growth and rapidly increasing living standards.

This reason of itself, however, is not sufficient to justify a decision to locate offshore. Firms must also possess some particular advantages or 'firm-specific assets' — such as technology or superior management expertise — to provide them with the competitive edge needed to combat inherent advantages of local firms in the overseas country (for example, better information about local laws, customs and business practices). Also, offshore production must be more cost-effective than exporting from Australia.

In many instances, firms wishing to tap into international markets have little or no opportunity to choose between exporting and producing offshore. It is uneconomic to trade some goods because of high transport costs (for example, manufactured goods such as bricks and other building products which have low value to weight ratios). And it is physically difficult (or impossible) to trade some other products — especially services, which typically require the provider to be close to the consumer (for example, construction, energy and many financial services). This is reflected in the large proportion of ADIA attributable to the services sector.

Box 1: Why Pioneer invested offshore

Pioneer is a major international supplier of building materials and pre-mixed concrete. Most of its output is now produced offshore.

The main reasons for locating offshore are:

- its operational and marketing expertise, which give it a competitive edge in other countries;
- its products, which are not readily exportable;
- the relatively large size and higher growth rates of some overseas markets; for example, the market for pre-mixed concrete is 12 times larger in the United States than in Australia; and
- merger regulation, which restricts expansion by the company in Australia.

Even when it is feasible to supply a market by exporting, benefits from locating close to users can warrant the establishment of offshore facilities. Firms argue that a commercial presence overseas can be critical to their longer-term success, by allowing them to develop a local image, tailor products more closely to users' needs and respond quickly to changing market conditions.

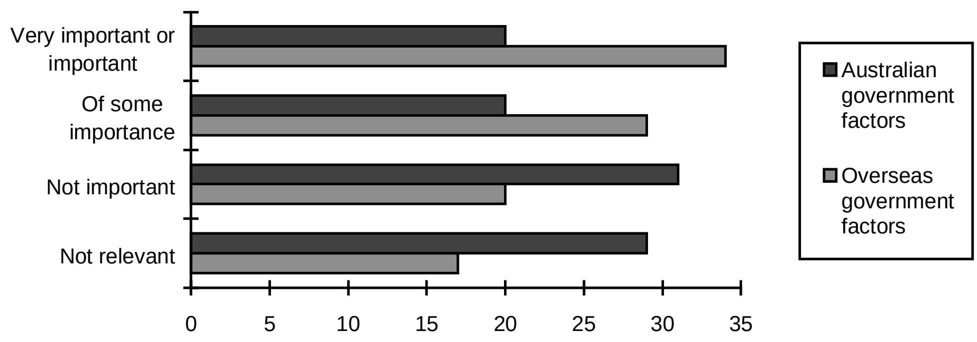
While market demand-related factors are the main reason for most firms locating offshore, other factors come into play.

For some firms, the availability or cost of inputs is an important influence on the decision to locate offshore. For instance, just as raw material availability is generally the overriding consideration for mining ventures, labour costs are central to locational decisions made by firms engaged in labour-intensive activities such as clothing and footwear manufacture.

Government policy-related influences, whether in Australia or overseas, appear to be of secondary importance for most offshore investment. However, they are central to some firms' decisions to locate offshore, and can play a role in determining the choice of country in which to invest.

A Commission survey of 150 mining, manufacturing and service sector firms revealed that 20 per cent of respondents considered domestic policy influences 'very important' or 'important' to their decision to invest offshore. The corresponding proportion for foreign government influences was 34 per cent (see Figure 2). However, the significance of government-related influences — particularly in Australia — varied markedly between sectors. They were of most significance to mining firms, and of least significance to service sector firms.

Figure 2: **Relative importance of government-related factors** (percentage of respondents)



Australian government measures identified by firms as helping to 'push' investment offshore include costs related to the taxation system, regulatory measures that prohibit some domestic mergers, land access and environment regulation, labour on-costs and regulation which constrains labour market flexibility. Foreign government influences which 'pull' or attract ADIA include tax and financial concessions, subsidised infrastructure and trade barriers. Some countries also employ measures which impede or ‘stop’ direct investment from Australia, such as foreign ownership restrictions.

Economic effects of ADIA

There are few rigorous studies of the economic implications of foreign direct investment for the source country. Data constraints which inhibit quantitative analysis and difficulties in determining alternative outcomes if offshore investments were not undertaken (the ‘counterfactual’ scenario) largely explain this shortcoming. The lack of suitable data also reduced the Commission’s capacity to quantify the economy-wide effects of ADIA.

The economic effects of a firm’s offshore investment depend crucially on the nature of the investment and the underlying motivation of the firm undertaking it. The implications for the economy as a whole, however, need not mirror the firm level effects. In assessing the effects of ADIA, it is also important to take account of the influence of government policies.

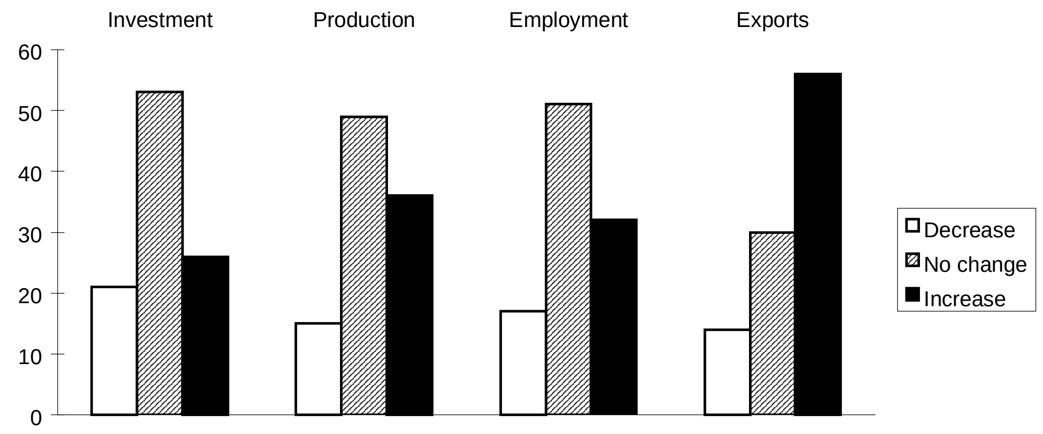
Effects on firms

Substantial benefits are attributed by firms to their offshore investments. Australian ‘parent’ enterprises consider that they:

- add to profitability;
- facilitate access to new technologies;
- provide superior and more timely information on market trends; and
- increase productive efficiency through greater exposure to the pressures of international competition.

Firms undertake offshore investment if they expect it to improve shareholder returns. An improvement in a firm’s financial position need not imply corresponding increases in its production, employment, exports or level of investment in Australia. The Commission’s survey results indicate, however, that this is a likely outcome (see Figure 3).

Figure 3: **Effects of ADIA on firms' domestic activity**
(percentage of respondents)



Economy-wide effects

In principle, the economy-wide effects of ADIA could differ from the firm level effects. For instance, offshore investment by some firms can lead to increased exports (and, hence, increased employment, production, etc) for other Australian firms — such as suppliers of components or other inputs used by the offshore venture. In this situation, the economy-wide effects on activity levels would be in the same direction as, and be greater than, those at the level of the firm. If offshore production displaced exports by other domestic firms, the opposite could be true.

In practice, ADIA is most likely to have a positive effect on activity levels in the economy.

Where investments are driven by *market demand-related* influences — which account for most ADIA — offshore investment and exports are more likely to be complements rather than substitutes. In part, this is because it is neither feasible nor economic to export many goods and services. In these circumstances, an offshore investment is unlikely to replace exports or to reduce domestic production and employment. Reductions would result only if the overseas investment occurred at the expense of domestic investment. However, there is little evidence to suggest that ADIA imposes a significant constraint on firms' capacity to undertake profitable domestic investments.

Investments driven by the *cost or availability of inputs* are also more likely to increase, rather than decrease, domestic activity levels. For example, investments to gain access to natural resources not available in Australia obviously cannot be at the expense of exports of that resource from Australia.

Some offshore investments made to take advantage of cheaper labour or other inputs could displace exports and jobs for particular firms. However, to the extent that these investments are in activities in which Australia is not internationally competitive (such as certain clothing and footwear manufacture), the feasibility of exporting from Australia is questionable, at least in the medium term. In these circumstances, offshore investment is often a means of enhancing the viability of the domestic base.

The findings of studies which examine the economy-wide impacts of offshore investment vary. In general, the theoretical models and more comprehensive overseas studies indicate that offshore investment has positive effects on the economy. The Commission’s own econometric analysis supports these findings. However, in some instances, these effects could have adjustment and distributional consequences. In particular, offshore investment is likely to increase the demand for skilled labour relative to less-skilled workers.

Policy measures may reduce the benefits

While ADIA is driven primarily by market demand-related factors, it also responds to government policies, both in Australia and overseas. From a government policy perspective, efficiency issues need to be considered where there are government-induced ‘distortions’ which affect the economic impacts of ADIA.

Relevant foreign policy influences are mainly ‘pull’ factors (such as financial concessions and trade barriers) which tend to increase ADIA, but there are also some ‘stop’ factors which prevent or impede ADIA (such as prohibitions on foreign investment in certain industry sectors). Although ‘pull’ factors are likely to impose costs on the host country, they are unlikely to reduce the benefits that accrue to firms investing offshore. But they are likely to distort the global trading environment and have adverse implications for Australia’s trade performance. Factors which ‘stop’ ADIA deny the possibility of benefits flowing to both Australian firms and the economy as a whole.

Of those Australian government measures which influence ADIA, most tend to increase it. To the extent that these influences ‘artificially’ shift the balance between domestic and offshore investments, they reduce the benefits from ADIA.

The adverse effect of government-induced distortions on ADIA does not materially alter the Commission’s assessment that ADIA has a positive impact on the economy. But such distortions can diminish the gains from ADIA and impose other costs on the economy. Hence, some government action is warranted. This should be directed at the source of the problem — inappropriate policy settings and regulations which distort the level and pattern of ADIA.

Government policy settings

While government policies have not been the predominant influence on offshore investment, they have been important for some firms. In other cases they have 'tipped the balance' in the decision to locate offshore, or influenced the decision to locate in one country rather than another. And, taken together, they can exert a more powerful influence. Moreover, once firms have overcome the costs and market risks of establishing operations offshore, their successive investment decisions become more sensitive at the margin to differences in government policy.

In this inquiry, the Commission focused on those areas of policy which either have been identified as playing a significant role in offshore location decisions, or have a particular effect on offshore investments. The Commission also sought to avoid duplicating work undertaken by previous studies.

Taxation of international income

In common with taxation systems employed by other countries, the arrangements for taxing the foreign-sourced income of Australian firms are complex. In part, this reflects the disparate objectives they seek to satisfy — collecting revenue in a way that has minimal effect on firms' decision-making while, at the same time, meeting equity objectives and minimising tax avoidance as well as compliance and administrative costs.

There is no consensus among taxation experts about the optimal configuration for any one country's international taxation regime. Nonetheless, in the Commission's view, the broad structure of Australia's *international* taxation system is appropriate. The system generally encourages domestic investors to allocate their capital so that foreign investments will be pursued only if they produce as high a return to Australia as would alternative domestic investments. This is not to deny the existence of fundamental weaknesses in other areas of Australia's taxation structure (for example, the imposition of taxes on many business inputs).

Some contend that *levels* of tax in Australia should be internationally 'competitive'. While it is important that corporate taxation in Australia compares favourably with that of other countries, this should not be regarded as the sole objective of taxation policy. Taxation of corporate income should be determined with a view to achieving the most efficient and equitable structure for the taxation system as a whole, while raising the revenue needed to meet Australia's own economic and social policy objectives.

Many participants expressed concern that the Australian imputation system discourages some offshore investment which would enhance national income. This is seen as a consequence of the current arrangements whereby a proportion of franking credits from corporate tax paid in Australia must be distributed to non-resident shareholders, even though the credits are of no benefit to some of them. It is contended that efficiency would be enhanced if international dividend 'streaming' were permitted to enable franking credits to be redirected to Australian shareholders.

In principle, streaming could improve efficiency in some circumstances by helping to ensure that profitable new overseas investments financed by foreign equity are not impeded by biases in the taxation arrangements. However, in other situations, it could encourage investment decisions financed by domestic equity which would provide lower national returns than alternative domestic investments. In the Commission's view, it is not clear that the benefits from streaming would exceed the associated costs.

Modifications are warranted to the rate of withholding tax applicable to repatriated dividends. Under Australia's double taxation agreements, a dividend withholding tax of at least 15 per cent generally applies. This level may have been appropriate in the past. However, two factors suggest the present bilateral arrangements should be reviewed to assess whether it would be appropriate to negotiate a lower level of withholding tax.

- First, Australia is now a significant capital exporter.
- Second, the imputation system now offsets significantly the withholding tax imposed by Australia on dividends remitted to foreign shareholders. Thus, the tax levied on repatriated dividends by Australia is generally well below that levied by foreign governments on profits remitted from the offshore operations of Australian companies.

All double taxation agreements should be reviewed as soon as practicable to assess the efficacy of negotiating a lower level of withholding tax.

There is also a need to review the reporting requirements applying to firms' offshore investments, to see if it would be cost-effective to reduce these requirements in areas where compliance or administrative costs are high. The review should encompass a detailed study to assess how the costs of complying with taxation requirements in Australia compare with those in comparable overseas countries.

Labour market regulation

The influence of labour costs on offshore investment decisions is largely confined to relatively labour-intensive manufacturing firms. A key factor is that, even allowing for significantly lower productivity, direct labour costs (wages plus on-costs) in some developing nations are substantially lower than those in Australia. There is a widespread perception among firms participating in the inquiry that some labour market regulation unnecessarily constrains flexibility and magnifies this disadvantage.

Large differences in direct labour costs will persist — they are a reflection of Australia's relatively high standard of living. In the absence of fundamental changes in taxation and national savings policies, the scope for reducing on-costs is also limited.

Government can help, however, to boost labour productivity by ensuring that labour market regulation does not limit unnecessarily the capacity of employers and employees to strike productivity-enhancing agreements. Recent reforms to the regulatory framework have promoted change in workplace relations and facilitated improved work practices. But many firms consider that the present arrangements still inhibit the adoption of more flexible work practices. These arrangements have encouraged some firms to move offshore. Productivity gains achieved through labour market reform in New Zealand are seen as indicative of improvements that could be achieved in Australia with more flexible labour market regulation.

Environmental regulation

Environmental regulation in Australia is more stringent than in many other countries. The additional costs which this entails may encourage some firms to locate offshore. Nevertheless, it is appropriate that Australia's environmental regulations reflect the characteristics of its own environment and the community's environmental objectives.

The Commonwealth Environment Protection Agency has drafted a voluntary code of practice to improve the environmental performance of Australian firms' operations offshore. However, little evidence has been provided to demonstrate that a significant problem exists.

Even if problems did exist, it is unlikely that the proposed code would be effective in addressing them. There is also a danger that such a code could evolve into regulation or 'quasi-regulation' (involving government sanctions against firms not becoming signatories).

If it could be demonstrated that the environmental performance of Australian firms operating offshore is unsatisfactory, voluntary codes being developed by industry, or international codes of practice, are likely to be more effective means of addressing the problems.

Native title implementation

An inevitable consequence of common law recognition of native title in the *Mabo (No. 2)* case and the introduction of the Native Title Act (NTA) is some increase in uncertainty about land access. However, mining and farming interests, as well as governments, consider that poor implementation processes are unnecessarily exacerbating uncertainty. Mining companies claim that this is contributing to an increasing proportion of investment being directed offshore.

Aboriginal and Torres Strait Islander representatives contend that these claims are overstated. They believe that any problems with delays and uncertainty will be overcome as precedents are created, administrative processes are 'bedded down' and mining firms increasingly appreciate the benefits of negotiating agreements with native title claimants and holders.

It is very difficult to assess the magnitude of the impact that the *Mabo (No. 2)* decision and the introduction of the NTA have had on mining activity. Available data are limited and there are problems in isolating the influence of the NTA from other factors which bear on investment decisions.

It is inevitable that implementation of the NTA will create some uncertainty and add to miners' costs. But if unnecessary uncertainty, or perceptions of such uncertainty, exist about the risks and costs of gaining access to land in Australia, some resources will be diverted to lower-yielding overseas ventures. The longer the uncertainties about native title persist, the greater will be the costs.

The Commission has taken the concept of native title embodied in the NTA as a 'given' for the purposes of this report. However, it considers that government action is warranted to improve the effectiveness of processes involved in the implementation of the NTA and reduce uncertainty.

Much of the uncertainty reflects a lack of clarity about the property rights inherent in native title. The unresolved status of pastoral leases is the major concern. In Western Australia, pastoral leases comprise about one-third of the existing land mass. Although the Commonwealth Government has decided recently not to take legislative action, the issue is currently under consideration by the High Court. In the event that the High Court's decision leaves further matters about pastoral leases outstanding, test cases should be expedited.

Unnecessary costs and delays in gaining access to land can also arise because of ready access to the 'right to negotiate' under the NTA. At present, native title claimants are accorded this right subject only to limited screening. Further, the right can be exercised over exploration and, again, over production. A more thorough screening test, such as the registration test proposed in the Native Title Amendment Bill, would mitigate the problem. The Government is also considering exclusion of exploration from the right to negotiate process. While this would be more effective than the expedited procedure in reducing transaction costs, the potential for adverse effects on native title would need to be addressed.

Administrative delays also would be reduced if State and Territory governments exercised their right to administer some of the processes required by the NTA or, as a minimum, coordinated other administrative processes (in particular, the granting of mining tenements) with the right to negotiate process.

Other domestic policy influences

While a range of other domestic policy measures bear on the efficiency of investment location decisions, participants identified two matters of particular concern: inefficiencies in the transport sector and the regulation of mergers. The former encourages offshore investment by reducing the competitiveness of Australian production, while the latter encourages relocation by reducing opportunities for domestic expansion.

Transport inefficiencies

Over the last decade, there has been significant reform of government transport businesses. Reforms have included administrative measures — such as the corporatisation of rail authorities and the introduction of uniform road charges for heavy vehicles — as well as initiatives to increase competition in the supply of transport services. While some improvements in efficiency have been achieved, the performance of different forms of transport varies considerably.

Within the transport sector, inefficiencies on the waterfront have the greatest impact on offshore investment decisions. Progress in lifting productivity on the waterfront has stalled over the last few years. The performance of Australia's main ports seems to be lagging well behind that of similar ports overseas. There is a need for further reform — including changes in work practices — to enhance the competitiveness of firms producing in Australia.

Merger policy

Participants in this inquiry, consistent with a number of surveys of firms, identified regulatory constraints on their ability to grow though mergers and acquisitions as one of the more important Australian government influences on their decisions to locate offshore.

Takeovers and mergers which "substantially lessen competition" are prohibited under the Trade Practices Act (TPA). However, most mergers have no anti-competitive effects and can enhance efficiency. They provide opportunities for the merged entity to reduce costs by exploiting economies of scale and scope, and the threat of takeover provides a powerful stimulus for companies and their managers to perform well. Hence, if the merger provisions of the TPA are to be effective, the associated administrative procedures of the Australian Competition and Consumer Commission (ACCC) must be able to identify those mergers whose anti-competitive consequences would outweigh any gains for the community from greater efficiency.

At the time of the draft report, the Commission argued that the Draft Merger Guidelines may have been subjecting more mergers to ACCC scrutiny than necessary, and that they provided insufficient guidance about some decision-making criteria. The revised Merger Guidelines subsequently released by the ACCC addressed a number of the Commission's concerns and proposals, including the provision of an additional 'safe harbour' for mergers in markets where imports have at least a 10 per cent share. The ACCC is reviewing the implications of raising the market concentration thresholds, as proposed by the Commission. It has also made provision for efficiency effects to be considered directly in the competition test. However, it is still unclear whether this will allow adequate consideration of efficiency aspects when assessing merger proposals.

International policy issues

Overseas government policies are perceived to have a greater influence than domestic policies on the offshore investment decisions of Australian firms. Some are 'pull' factors which attract Australian investment. Common examples include trade barriers, tax concessions, grants, import duty rebates and subsidised infrastructure. But others — such as constraints on profit repatriation, foreign ownership restrictions and local content requirements — act as a brake on ADIA. Both sets of factors reduce efficiency by distorting decisions about the location of new investment.

Increasing awareness of the benefits associated with removing impediments to inward foreign investment has resulted in a global trend to liberalise investment regimes. However, further work is required to identify and analyse the effects of the substantial barriers to foreign investment that remain. To this end, the Australian Government should promote further studies, especially within the APEC region.

It is in Australia's interests — and the interests of the countries imposing the restrictions — to accelerate investment liberalisation. While the pace of reform will depend ultimately on greater recognition of the benefits within each country, Australia should continue its efforts to develop a Multilateral Agreement on Investment within the OECD. It should also seek to have an investment agreement negotiated within the World Trade Organization.

FINDINGS AND RECOMMENDATIONS

Reasons for locating offshore

1. Market demand-oriented influences are typically the most important determinants of Australian direct investment abroad in sectors other than mining.
2. The most significant market demand-oriented influences are: greater growth opportunities in offshore markets; benefits from locating in close proximity to users; and advantages of diversifying market risk by locating in a number of markets.
3. The prospective availability of mineral resources is usually the key determinant of Australian direct investment abroad by mining firms.
4. The cost of labour can also be an important influence on Australian direct investment abroad, particularly for firms engaged in labour-intensive manufacturing activity.
5. Government-related factors, although important for some firms (especially within the mining sector), are generally not a dominant influence on offshore investment.
6. The main Australian government influences include: labour market regulation and on-costs; merger policy; and land access regulation. Important foreign government influences include: taxation arrangements; other financial concessions; and trade barriers.

Economic effects of offshore investment

7. Offshore investment by Australian firms results in short-term and long-term benefits to Australia. Overall, offshore investment can be expected to increase national income and enhance the wealth of the Australian community, notwithstanding the fact that certain types of offshore investment may displace some domestic activity.
8. For the majority of firms, Australian direct investment abroad complements exports and, in aggregate, it is also likely to enhance Australia's net export performance.

9. Australian direct investment abroad in general is unlikely to reduce domestic investment. Aggregate data show a positive correlation between offshore and domestic investment.
10. The effects of Australian direct investment abroad on Australian production and employment levels reflect the effects on domestic investment and net exports. The economy-wide impact is likely to be positive, although it will involve some adjustment pressures.
11. Australian direct investment abroad is likely to increase the demand for skilled relative to unskilled labour.
12. Australian direct investment abroad has involved higher rates of reinvestment of overseas earnings (and, thus, lower repatriation of profits) than on average across Australian businesses.
13. Profits earned from offshore investments add to the wealth of Australians, irrespective of when they are repatriated.
14. Current tax arrangements work to ensure, one way or another, that the profits from offshore investment generate an appropriate level of Australian tax revenue.
15. Australian government and foreign government policy measures can artificially alter the level and distribution of offshore investment by Australian firms and reduce the associated benefits to Australia. Government action to reduce or remove these distortions would enhance the benefits to Australia of offshore investment and bring wider gains.

Data deficiencies

16. Official data collected on Australian direct investment abroad are limited and not sufficient to permit comprehensive analysis.
17. The Australian Bureau of Statistics should assess the efficacy of extending the statistical information collected about Australian direct investment abroad.

Government policy matters

Taxation

18. There are some fundamental weaknesses in Australia's taxation structure. Nevertheless, in broad terms, the structure of Australia's *international* taxation system encourages domestic investors to allocate capital so as to maximise returns to the Australian community.

19. While it is important that the taxation of corporate income in Australia compares favourably with that in other countries, it should be determined with a view to achieving the most efficient and equitable structure for the taxation system as a whole, and to raising the revenue required to meet Australia's economic and social objectives.

20. Double taxation agreements between Australia and other countries should be reviewed as soon as possible to assess whether a lower level of dividend withholding tax would be appropriate.

21. It is not clear that the benefits from permitting international dividend 'streaming' would exceed the associated costs.

22. Compliance and administrative costs associated with Australia's Controlled Foreign Company measures and transfer pricing reporting requirements should be reviewed to assess whether it would be cost-effective to reduce the existing requirements. The review should include a detailed study to assess how compliance costs in Australia compare with those in comparable overseas countries.

Labour market regulation

23. There is little scope to reduce labour on-costs significantly without fundamental changes in taxation and national savings policies.

24. There is a widespread perception among firms participating in the inquiry that the present labour market arrangements are complex and costly to operate within, and inhibit the adoption of more flexible work practices. This underlines the need for continuing reforms to facilitate more productive and competitive workplaces.

Environmental regulation

25. In determining the level of environmental regulation in Australia, the appropriate benchmark is Australia's own environmental needs and objectives, not the level of regulation applying overseas.

26. There is little information about the extent of environment problems associated with the offshore operations of Australian firms. Even if it can be demonstrated that there are shortcomings in the environmental performance of Australian firms' offshore operations, it is unlikely that the environmental code of conduct drafted by the Commonwealth Environment Protection Agency would be effective in addressing the problems.

Native title legislation

27. A lack of clarity about the property rights associated with native title, rather than native title per se, is the major cause of the current increased uncertainty about access to natural resources.

28. Although increased uncertainty about land access arising from the *Mabo (No. 2)* decision and the Native Title Act will affect mining exploration and production, at the present time it is very difficult to assess the magnitude of these effects.

29. To clarify native title property rights, test cases involving any outstanding matters of principle need to be heard and determined by the High Court as soon as possible.

30. Giving native title representative bodies the power to endorse claims or a monopoly role in negotiations could be of assistance in identification of native title claimants. However, both approaches have significant disadvantages. If either were chosen, it would be important that its effectiveness be reviewed within three years.

31. A more thorough screening test should be applied to native title claims before the right to negotiate is given. The registration test proposed in the Native Title Amendment Bill would serve this purpose.

32. The States and Territories should accelerate the establishment of their own future acts regimes under the Native Title Act or, at least, amend their processes so that they are better coordinated with the right to negotiate process.

33. The exclusion of prospecting and exploration from the right to negotiate process is likely to be more effective than the expedited procedure in reducing transaction costs. However, some types of exploration activity could have significant impacts on native title. Accordingly, if exclusion is implemented, it should not apply to activity resembling test production. There is a need also to address concerns about the adequacy of Aboriginal heritage legislation.

34. Consideration should be given to reviewing the requirement for governments to be parties to agreements under the proposed amendments in the Native Title Amendment Bill.

35. Apart from any substantive amendments, the Native Title Act should be reviewed with a view to simplifying its language and structure.

Merger regulation

36. The ACCC's revised Merger Guidelines have addressed a number of concerns about restrictiveness and lack of transparency in the draft guidelines. Key issues remaining include the scope to raise the market share thresholds (currently under review by the ACCC) and the extent to which efficiency considerations can be brought to bear in competition assessments.

International policy issues

37. Many countries have reduced their barriers to foreign investment, but significant impediments remain. It is in Australia's interests that these barriers be reduced.
38. The Australian Government should promote further studies, especially within APEC, to document and analyse the economic effects of impediments to trade and investment.
39. Australia should continue its efforts to develop a Multilateral Agreement on Investment within the OECD. It should also seek to have an investment agreement negotiated within the World Trade Organization. Initially, this may need to be an agreement among a sub-group of WTO members.
40. There may also be benefits to Australia from pursuing bilateral and regional agreements, provided they do not jeopardise, or defer, the development of a multilateral agreement.

The Commission draws attention to its comments about the need to improve efficiency in the transport sector.

1 INTRODUCTION

This report is primarily concerned with the underlying motivation for, and the economic effects of, investments undertaken by firms in Australia to relocate part, or all, of their operations offshore. Such investments are not a new phenomenon — Australian firms have been investing abroad since the mid-nineteenth century. However, the issue has assumed increased prominence following a large upsurge in offshore investment during the latter part of the 1980s. This increase stimulated debate about whether offshore investment by Australian firms has a positive influence on the economy (for example, by providing additional income and growth opportunities) or a negative impact (for example, by reducing employment and exports).

The Australian Stock Exchange summarised the recent debate as follows:

> ... direct investment abroad should be viewed in the context of business activities in an open and international environment. However, the public debate, often motivated by specific interest groups, would have it that such investment abroad necessarily has an adverse effect on employment, investment, exports, technological development and taxation revenue. What is often overlooked are the benefits which may result from such investment, such as access to world markets, enhanced returns for firms investing overseas and the increasing sophistication of such firms in a competitive international environment (Sub. 6, p. 1).

Similarly, Austrade commented:

> While there is strong support [for outwards investment] among business circles, there appear to be some questions remaining at the general community level as to whether this really is a good thing for the Australian economy and whether such investment is at the expense of investment in local enterprises (Sub. 25, p. 15).

The increase in Australian direct investment abroad (ADIA) is consistent with a global increase in foreign direct investment. It is related to the progressive dismantling of barriers to capital movements and the closer integration of national economies. These developments suggest that offshore investment by Australian firms could well become an even more prominent feature of the Australian economy. In these circumstances, it is important to understand the implications of such investment. To date, economic research has focused predominantly on investment by foreigners in Australia. Relatively little is known about the economic effects of offshore investments by Australian firms. This inquiry has provided an opportunity to address this shortcoming, and to consider the appropriate stance of government in relation to initiatives by Australian firms to locate part or all of their operations offshore.

The scope of the inquiry

The terms of reference for the inquiry (see page xii) required the Commission to report by 31 August 1996 on:

- key factors affecting the decisions of firms to locate offshore, and the implications of those decisions for Australia. In particular, it was required to examine any institutional, regulatory or other arrangements subject to influence by governments in Australia or overseas which lead to inefficiencies in location decisions, and to advise on courses of action to remove or reduce those inefficiencies; and
- the short and long-term implications of offshore location decisions for Australia, including the effects on employment, national income, net export performance, taxation and the treatment of repatriated profits, and changes in the size and composition of Australia's industry base.

The terms of reference also requested the Commission to provide "examples of past successes or failures of firms locating offshore". While many firms willingly pointed to successful overseas ventures — many of which are discussed in subsequent chapters — firms were, quite naturally, not as forthcoming with details about unsuccessful ventures. Nonetheless, discussions with participants revealed that there have been failures, some of which have had significant adverse repercussions for firms and their shareholders. However, the failure of some investments (and the emergence of new ones) is an inevitable consequence of the competitive environment in which most businesses operate. It is not something which is peculiar to firms with offshore investments.

The Commission received no evidence to suggest that the failure rate of offshore businesses established by Australian firms is significantly different from that of domestic firms, or that the failures are symptomatic of any underlying weakness in government policy. Similarly, there does not appear to be any single factor which explains the failure of some offshore ventures. The reasons for failure are varied, ranging from underestimation of the risks involved in establishing operations in foreign countries to an inadequate understanding of overseas market conditions.

What firms are included?

The Commission interpreted the terms of reference to include locational decisions made by Australian subsidiaries of foreign-owned firms, as well as decisions made by Australian-owned firms. These decisions encompass the acquisition of existing overseas firms as well as greenfields developments, whether undertaken solely by an Australian firm, by an Australian firm in partnership with a firm in the host country or in partnership with a firm from a third country.

Direct investment is the focus

It is important to recognise that the terms of reference cover only overseas investments made by Australian-based firms for the purpose of locating all or part of their operations overseas (referred to in this report as Australian direct investment abroad (ADIA)). They do not cover offshore investments which are intended primarily to supplement corporate income without shifting the firm's production base. The latter investments — commonly referred to as portfolio investments — include overseas loans, deposits with foreign financial institutions and purchases of overseas bonds and corporate equities.

ADIA is commonly defined as overseas investments sufficient to provide the firm making the investment with 'significant influence' over the key policies of overseas enterprises in which it invests. While such investments typically involve the transfer of capital overseas, they may also involve the overseas transfer of technology and managerial skills. (The level of investment required to enable an Australian firm to exercise 'significant influence' over a foreign company is discussed in the following chapter.)

The Commission's approach

It needs to be recognised that ADIA is only one component of capital and, in many circumstances, would ideally be considered in a framework which also takes account of other capital flows (such as portfolio investment abroad, inward foreign investment and domestic investment). Where appropriate, the Commission has identified these linkages. However, in accordance with its terms of reference, it has focused predominantly on ADIA.

In keeping with its policy guidelines, the Commission has assessed the effects of offshore location decisions by Australian firms in an economy-wide context. Thus, the short-run and longer-run effects of offshore investments have been assessed not only from the perspective of individual firms, but also from the perspective of the economy as a whole.

The circumstances underlying decisions to locate offshore differ considerably between firms. Furthermore, it is evident that a wide range of factors can impinge on these decisions. Consequently, the Commission has focused on those issues which are relatively more important and which are more amenable to influence by government, concentrating in areas where further analysis may contribute most to public policy formation. In addressing these matters, the

Commission has sought to build upon, rather than duplicate, work undertaken by other agencies.

The policy guidelines require the Commission to have regard to the desire of the Commonwealth Government to encourage the development of efficient industries, facilitate structural adjustment and reduce unnecessary industry regulation. They also require that the Commission report on the social and environmental consequences of any recommendations it makes.

Inquiry process

Instead of initial public hearings, the Commission undertook an extensive round of informal consultations with representatives of industry organisations, companies, government agencies, land councils and other community groups, and with academics. This provided an opportunity to obtain a wide spectrum of views and to learn at first hand of the circumstances and strategies of many individual firms. In addition, round-table discussions with members of the Australian Chamber of Commerce and Industry (ACCI) were held in Sydney and Brisbane, and a round-table of experts on international taxation matters was held in Canberra. Discussions were also held in New Zealand with government agencies, Australian firms located in New Zealand and local firms which have established operations in Australia.

A feature of the meetings was the participation, in most cases, of chief executive officers. This increased significantly the benefits derived from the visit program.

Following the release of the draft report in April 1996, public hearings were held in Canberra in early July to allow participants to comment on the Commission's draft findings and recommendations. To enable one Western Australian participant to comment on the draft report, a video conference was held in lieu of a normal public hearing.

Individuals and organisations visited are listed in Appendix A, as are those who provided written submissions, participated in round-table discussions or presented a submission at the public hearings.

Very little information is available about the effects of ADIA on firms or the economy generally. Consequently, with the assistance of the Australian Bureau of Statistics (ABS), the Australian Chamber of Manufactures (ACM) and the Metal Trades Industry Association (MTIA), the Commission surveyed some 150 firms to obtain information about the impact of their offshore investments on their activities in Australia. In addition, the Business Council of Australia kindly agreed to attach additional questions to its half-yearly Survey of

Business Conditions to allow the Commission to gather additional information on the reasons underlying firms' decisions to locate offshore.

Report structure

The report begins by outlining recent trends in ADIA and indicating its significance to the Australian economy. The reasons underlying offshore investment by Australian firms are explored in Chapter 3. The following chapter discusses the effects of ADIA on firms and the economy generally. The remaining chapters discuss a range of factors subject to influence by government which affect decisions about the location of new investment:

- Chapters 5 and 6 consider issues relating to the taxation of foreign-sourced income and the labour market, respectively;
- environmental matters are discussed in Chapter 7;
- issues concerning the implementation of the Native Title Act are canvassed in Chapter 8; and
- the final two chapters consider other domestic policy influences — namely, transport issues and competition policy — and some international policy issues to do with global impediments to direct foreign investment.

2 AUSTRALIAN DIRECT INVESTMENT ABROAD

An understanding of the nature and extent of investments by Australian firms to locate part, or all, of their operations offshore is a prerequisite for analysis of the effects of such investment on the economy and also for assessing the need for any action by government. This chapter examines changes in the level and distribution of such investment. It also describes its significance relative to other forms of capital outflows (such as portfolio investment) and inward foreign investment.

The chapter commences by outlining data constraints relating to official statistics of ADIA. Subsequent sections discuss: trends in ADIA (Section 2.2); its growing significance to the Australian economy (Section 2.3); and other salient characteristics of ADIA (Section 2.4). The motives underlying offshore investment by Australian firms are discussed in detail in the next chapter.

2.1 Data deficiencies

The most reliable indication of the level and pattern of offshore investment by Australian firms is provided by data on ADIA collected by the ABS.

Definition of ADIA

ADIA is defined by the ABS as net capital investments made by Australian residents in non-resident (foreign) enterprises in which they have at least a 10 per cent equity interest (whether by voting stock or equivalent beneficial equity interest). Thus, it includes offshore investments in which Australian residents have a *controlling influence* over foreign enterprises, as well as investments in which the influence falls short of control, but is nonetheless regarded as significant. ADIA includes the reinvestment of earnings by overseas subsidiaries and the net value of lending to, and borrowing from, subsidiaries abroad. Investments with less than the 10 per cent equity threshold are classified as ‘portfolio’ investments (as are virtually all other investments by resident Australian corporations and individuals). ADIA can take place via investment in a new activity or as a result of a takeover of an existing investment.

The definition of ADIA employed by the ABS is consistent with that adopted by international agencies reporting on international investment, such as the International Monetary Fund. Nonetheless, it is possible that ADIA statistics do not accurately portray offshore investments by Australian firms. There are four areas of concern.

- The first involves the criterion for distinguishing between ADIA and portfolio investment. Discussions with industry suggest that very few Australian firms wishing to establish offshore operations would seek equity levels in overseas firms as low as 10 per cent, because that would be unlikely to provide them with sufficient control.[1] Consequently, official ADIA statistics could overstate the level of investments undertaken by Australian companies for the purpose of "locating part or all of their operations offshore".
- Second, there is a discontinuity in the data from 1985–86 when the equity proportion used to differentiate ADIA from portfolio investment was reduced from 25 per cent to 10 per cent.
- The third difficulty arises because of the exclusion from the data of Australian offshore investment financed from foreign borrowings by offshore subsidiaries.
- Lastly, to the extent that some ADIA has been undertaken primarily for short-term financial gains (for example, so-called asset stripping overseas), in some years the ABS data may overstate investments by firms for the purpose of establishing offshore operations.

The ABS has advised that the effect of the definitional change was negligible. Nevertheless, because of the other difficulties, ADIA statistics should be treated as only broadly indicative of offshore investment undertaken by Australian firms to locate all or part of their operations offshore.

Limited data availability

Academics and representatives of a number of companies with whom the Commission met expressed dissatisfaction with the limited official data about ADIA. A major shortcoming is perceived to be the unavailability of data comparable to that published in the United States and Japan, particularly information at the industry and firm level about the size, structure, production, employment and trade of Australian multinational companies. Because of these data deficiencies, the Commission itself was constrained in assessing the effects of ADIA on the Australian economy.

1 This is not to deny that a 10 per cent equity could provide the investing enterprise with significant *influence* over overseas businesses.

In responding to the draft report, the ABS reiterated that the statistics are produced in accordance with International Monetary Fund standards to ensure international comparability, adding:

> ... however we do note that further detail, within the overall international standards and frameworks, may be required for more comprehensive analysis (Sub. 39, p. 1).

The ABS also noted that, as a consequence of Australia becoming a signatory to the General Agreement on Trade in Services, it will be required, in time, to collect greater detail about the operations of foreign affiliates of Australian companies.

In view of the increasing importance of, and growing policy interest in, ADIA, an increase in the data collected — including detailed data at the industry level which can be linked to the characteristics of domestic parent enterprises — would be useful for policy analysis. The information would not need to be collected each year.

In its draft report, the Commission proposed that the ABS examine the possibility of expanding the data collected about ADIA. It acknowledged that a significant cost is involved in collecting, processing and publishing comprehensive statistics of the type produced by the ABS. In response, the ABS stated that establishment costs would be of the order of $200 000, with collection costs amounting to an additional $250 000. Additional costs would be imposed on respondents.

The Commission supports the suggestion by the ABS that it undertake research into the feasibility of collecting additional data to help it assess the efficacy of extending the present data collection.

2.2 Trends in ADIA

Relatively little research has been done on the nature and extent of ADIA. However, recent studies by the Bureau of Industry Economics (BIE 1995a and 1995f), based on published and unpublished ABS data, provide useful information on trends in ADIA. This chapter draws partly on these studies, as well as on ABS data.

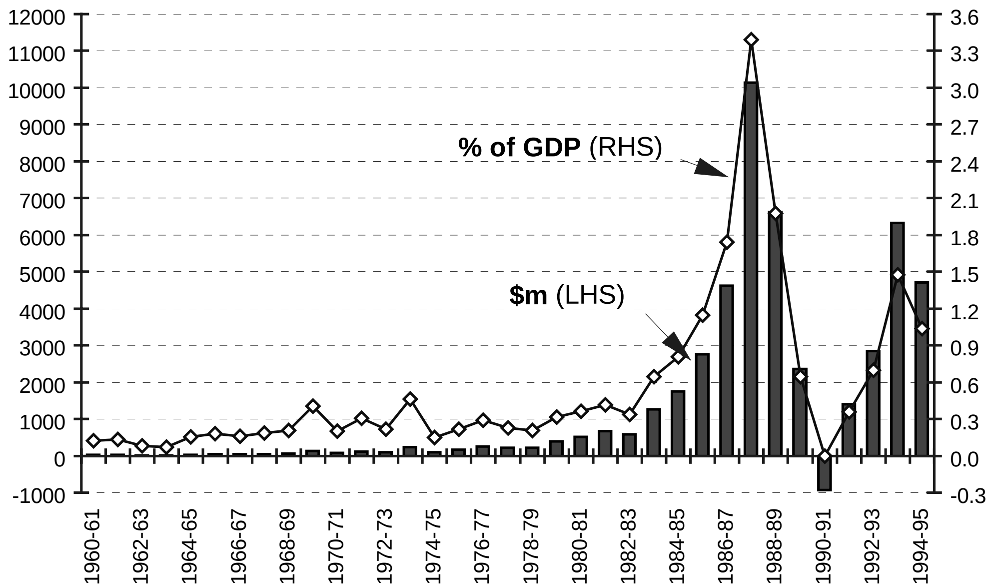
Inward foreign investment has been a feature of the Australian economy since the beginnings of European settlement. Although not widely known, there is also a long history of offshore investment by Australian firms. For example:

- in 1853, the Bank of New South Wales established branches in London to facilitate the transfer of funds and bullion from Australian goldfields;

- in 1882, CSR invested in the Fijian sugar industry in an attempt to prevent it from becoming a competitive threat to the Queensland industry; and
- during these early times, Burns Philp established operations in a number of South Pacific countries, including Papua New Guinea and New Zealand.

The level of ADIA has increased considerably since those times. Nevertheless, for many years the total annual value of ADIA was relatively modest. For instance, during the 1960s and 1970s, annual ADIA outflows averaged less than $200 million, which was less than 0.5 per cent of GDP (see Figure 2.1).

Figure 2.1: Outflows of ADIA, 1960–61 to 1994–95[a] (current prices)



a The negative value of outflows in 1990–91 resulted from a withdrawal of assets in corporate equities in excess of outflows in that year.

Sources: ABS, Cat. Nos. 5363.0, 5305.0 and 5204.0.

In subsequent years annual ADIA increased markedly. During the latter part of the 1980s particularly sharp increases were recorded, although with substantial year-to-year variations in outflows. In 1987–88, ADIA reached an all-time high — in excess of $10 billion, equivalent to about 3.4 per cent of GDP. Indeed, in that year, ADIA exceeded direct investment inflows for the first time.

Several factors contributed to the increase in ADIA in the mid-1980s. In Australia, financial market deregulation (in particular, the removal of exchange controls in 1983) made it easier for Australian firms to engage in ADIA. At the same time, an easing of financial controls and the relaxation of restrictions on foreign investment by many overseas governments increased the market opportunities available to Australian firms. In a study of international direct investment policies during the 1980s, the OECD (1992b) commented that:

> ... the 1980s saw substantial progress by Member countries as a whole in doing away with the restrictions on foreign direct investment (p. 8).

The increased access to international capital markets provided by the liberalisation of financial markets accounted for part of the surge in Australian equity investment abroad, including ADIA, being financed by foreign borrowings. This contributed to significant increases in national debt levels. The Reserve Bank of Australia (1990) said:

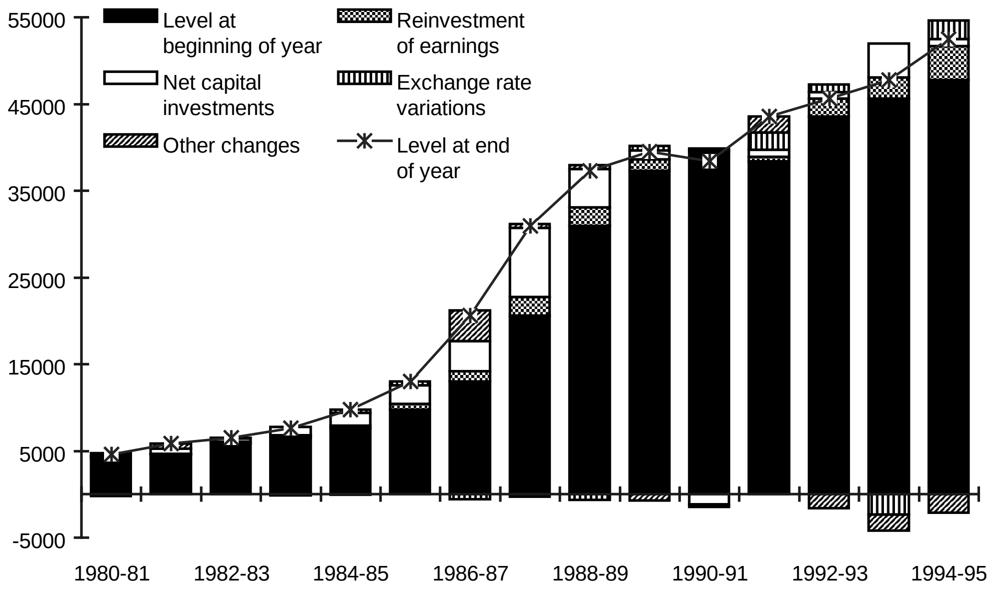
> ... the increase in net debt over the second half of the 1980s more than financed the current account deficit; it financed the expansion of Australian equity investment abroad as well. Had that expansion not taken place, Australia's net foreign debt would have been much lower — in rough terms, about $40 billion lower (pp. 22-3).

Over the last decade, ADIA has tended to increase with GDP growth and decline during periods when economic growth has fallen. Indeed, deteriorating economic circumstances explain much of the decline in ADIA in the three years after 1987–88. For instance, after the share market collapse in late 1987, rising interest rates and the onset of the recession, coupled with a downturn in some major developed economies, forced a number of large Australian companies to sell overseas assets to meet their financial commitments. Indeed, in 1990–91, about $4 billion of investment in corporate equities was withdrawn from abroad.

Coinciding with strong economic growth in Australia, and improving economic conditions and continued liberalisation of foreign investment regulations in many other countries, annual outflows increased steadily after 1990–91. In the three years to 1994–95, ADIA averaged $4.6 billion per annum. This was equivalent to 1.1 per cent of GDP, well above the average of 0.3 per cent in the preceding three years, but considerably less than the average of 2.4 per cent in the three years to 1988–89.

Variations in ADIA over the last decade or so are reflected in the aggregate value of the stock of ADIA (see Figure 2.2). Thus, the total value of foreign financial assets held by Australian residents increased significantly between 1985–86 and 1989–90, but subsequently fell slightly in 1990–91. Since then, the upward trend in ADIA stock has resumed. At 30 June 1995, the stock of ADIA was around $52.5 billion.

Figure 2.2: Stock of ADIA, 1980–81 to 1994–95[a,b]
($ million, current prices)



a The level at the end of year is commonly referred to as the *stock* of ADIA. It is the sum of the level at the beginning of year, net capital investments, reinvestment of earnings, exchange rate variations and other changes. The component 'other changes' includes changes in the market value of assets during the reporting period.
b Annual outflows of ADIA are the sum of net capital investments (or disinvestments) and the reinvestment of earnings. Net capital investments are transactions resulting from purchases or sales of equities, and lending or borrowing from abroad.
Sources: ABS, Cat. Nos. 5363.0 and 5305.0.

2.3 Significance of ADIA

Although the level of ADIA has risen markedly over the last decade, it is useful to put ADIA's role in the Australian economy in perspective. Some indication is provided by the comparisons made with GDP in the previous section. However, a better understanding can be gained by comparing ADIA with other domestic economic aggregates, and with the direct investment abroad undertaken by other developed nations.

Comparisons with other domestic indicators

Relevant domestic indicators include:

- the total level of all forms of Australian investment abroad;

- income from other overseas investments;
- foreign direct investment in Australia; and
- private domestic investment.

Australian investment abroad

The overall stock of Australian investment abroad comprises overseas investments made by both the 'official' and business sectors. Business sector investment offshore broadly consists of ADIA and portfolio and other investments. Official sector investment includes overseas investment by government agencies (other than government trading enterprises) and foreign asset holdings of the Reserve Bank.

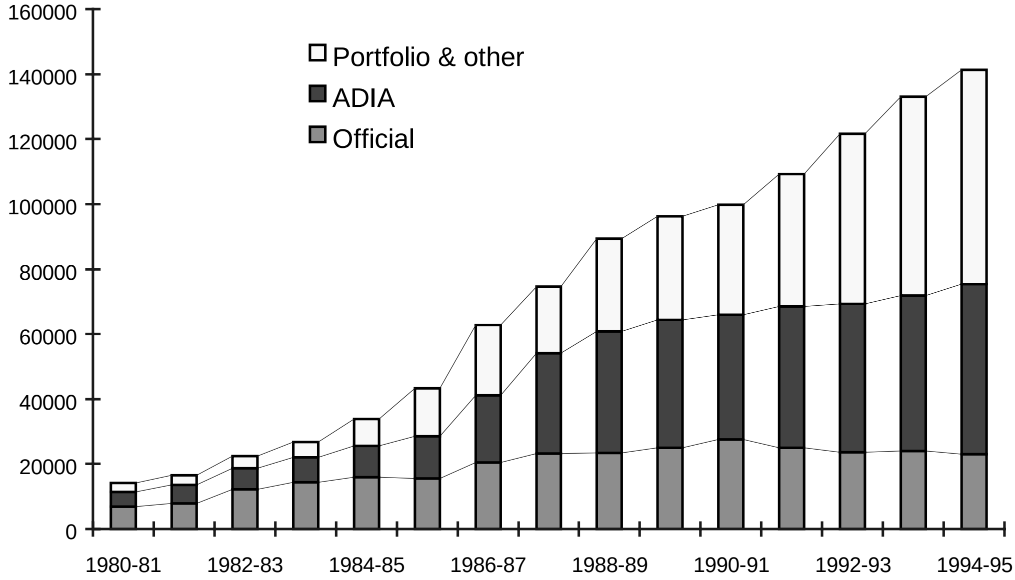
ADIA represents a sizeable and increasing proportion of total Australian investment abroad — around 37 per cent in 1994–95 (see Figure 2.3). Portfolio and other investment is the largest and most rapidly growing component of Australian overseas investment, comprising 47 per cent of the stock of all investment abroad in 1994–95. The share of official investment has declined over the last decade. In 1994–95, it represented 16 per cent of all Australian offshore investment.

Income from other overseas investments

Real income derived from ADIA has also risen substantially over the last decade or so, from $865 million in 1980–81 to $4166 million in 1994–95 (see Figure 2.4). Despite steady increases in income from portfolio and other investments overseas, income from ADIA continues to account for the bulk of total private overseas investment income — about 75 per cent in 1994–95.

Reinvested earnings have represented the largest component of ADIA income — on average around 70 per cent over the last decade (see Figure 2.4). The remainder — distributed earnings — has been mainly in the form of dividends rather than remitted profits ($295 million and $149 million, respectively, in 1994–95).

Figure 2.3: Stock of Australian investment abroad, by type, 1980-81 to 1994–95
($ million)

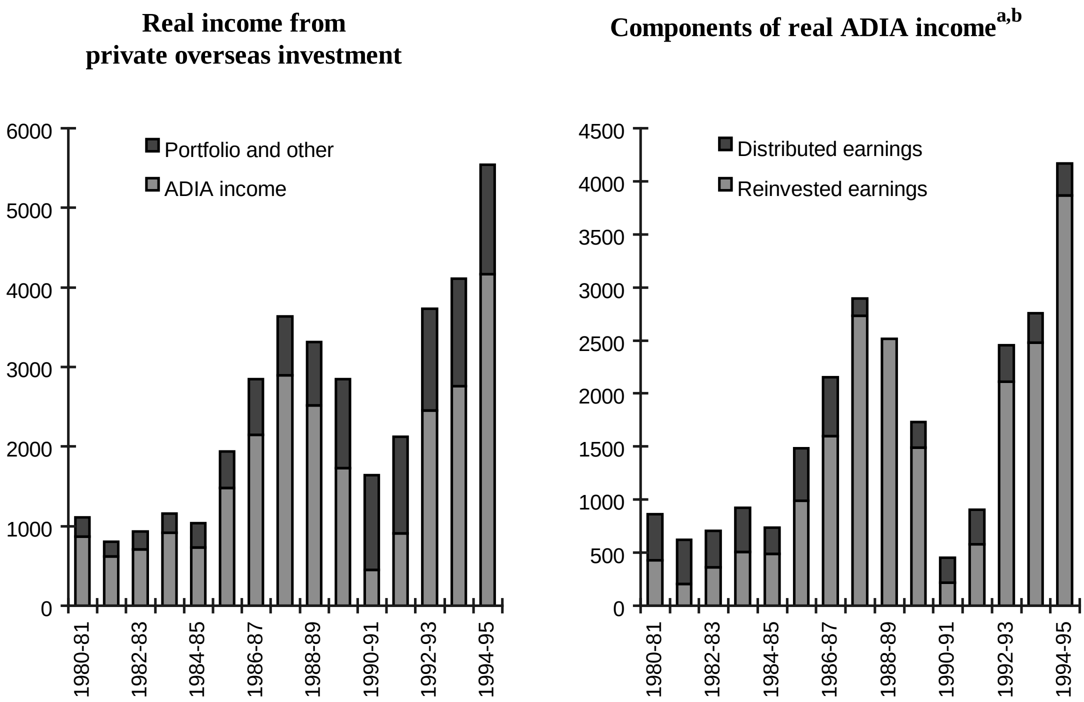


Sources: ABS, Cat. Nos. 5363.0 and 5305.0.

The rate of return achieved on ADIA has varied considerably over time and between regions (see Table 2.1). In the five years to 1994–95, the estimated average nominal rate of return was 4.4 per cent, well below the return achieved in the previous five-year period. Lower returns could reflect, in part, the time required to develop overseas businesses after the large growth of investment in the second half of the 1980s. Over the five years to 1994–95, the rate of return did not vary significantly across the regions and countries shown in Table 2.1, other than Papua New Guinea where the average rate of return (10 per cent) was much higher.

The average rate of return earned overseas in 1993–94 by Australian manufacturing firms included in a BIE survey (BIE 1995f) was lower than the average return earned domestically. On the other hand, service sector firms covered by the survey reported higher average returns on overseas investment than on domestic investment. Both groups of respondents reported that they expect to earn a higher rate overseas than they will at home over the five-year period to 1999. A majority of respondents to a survey undertaken by the Commission (see Appendix D) reported that ADIA increased their profitability.

Figure 2.4: Real income from overseas investment, 1980–81 to 1994–95 ($ million, 1994–95 prices)



a ADIA income is the proportion of earnings attributable to Australian direct investors after foreign company taxes, but before foreign withholding taxes and Australian taxes. Before 1985–86, direct investment income was reported after the deduction of withholding taxes.

b ADIA income comprises reinvested and distributed earnings. Reinvested earnings are imputed transactions — the actual income is not repatriated to Australia. Distributed or repatriated earnings include dividends, remitted profits and interest income.

Sources: ABS, Cat. Nos. 5305.0 and 5363.0.

Table 2.1: Estimated nominal rates of return[a] from ADIA, selected countries and regions, 1985–86 to 1994–95 (per cent)

Average	*United States*	*New Zealand*	*United Kingdom*	*ASEAN*	*Papua New Guinea*	*Total*
1985–86 to 1989–90	3.7	9.1	5.3	12.5	5.5	6.5
1990–91 to 1994–95	4.2	4.7	3.5	5.4	10.3	4.4

a Rates of return were derived by dividing ADIA income (including reinvested earnings) by the market value of ADIA stock.

Source: IC estimates based on ABS data.

Foreign direct investment in Australia

As a rule, ADIA has been less than foreign direct investment (FDI) in Australia. Outflows of ADIA have exceeded FDI inflows in only two years: 1987–88 and 1993–94. This is not surprising given the shortages of domestic savings relative to investment opportunities in Australia.

During the 1970s and early 1980s, ADIA was typically less than 30 per cent of inflows. However, following increases in ADIA in the mid to late 1980s, the gap has narrowed. Over the last decade or so, Australian direct investment abroad, on average, amounted to a little over 60 per cent of inflows.

Nevertheless, the *stock* of ADIA remains substantially lower than FDI stocks in Australia. In 1994–95, the stock of ADIA was valued at $52.5 billion, compared with the stock of FDI in Australia of $128.6 billion.

Private domestic investment

Annual flows of ADIA are small relative to private non-dwelling domestic investment, and are also more volatile. In 1994–95, ADIA flows were equivalent to 10 per cent of domestic private investment (see Figure 2.5). Consistent with the fluctuations in annual flows, ADIA as a proportion of domestic investment peaked at about 27 per cent in 1987–88 and dropped to around zero in 1990–91.

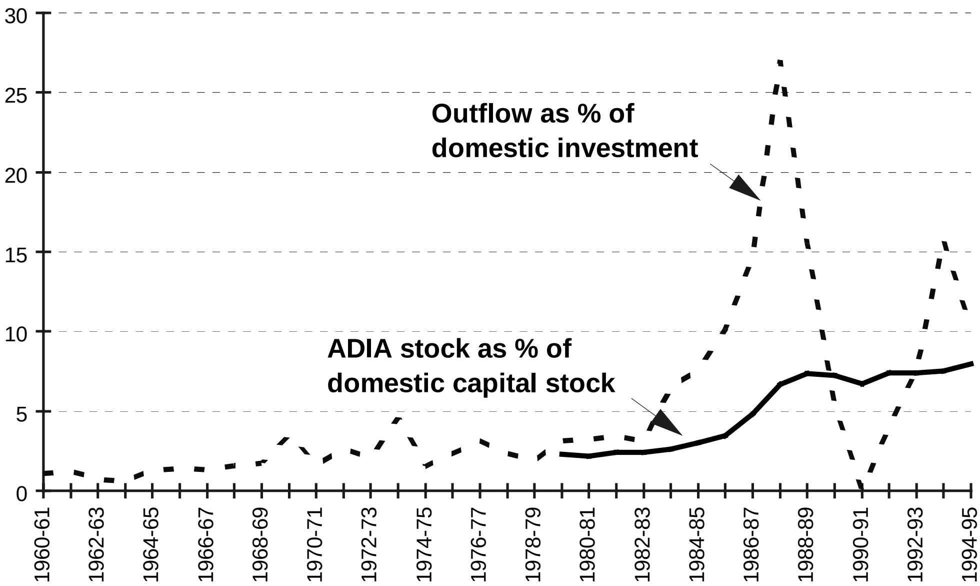
While the surge in offshore investment in the second half of the 1980s resulted in the accumulated value of ADIA increasing by over 200 per cent, the stock remains small relative to the domestic capital stock (8 per cent in 1994–95). Prior to the rapid increase in ADIA in the late 1980s, the stock of ADIA was equivalent to only around 3 per cent of the private domestic capital stock.

International comparisons

The growth in ADIA needs to be seen in the context of global capital movements and international trends that have emerged over the last decade or so.

The rapid increase in overseas direct investment witnessed in the late 1980s was not unique to Australia, but was part of a world-wide trend. For example, average annual world direct investment abroad increased (in nominal terms) from $US43 billion during the period 1981 to 1985, to $US168 billion between 1986 and 1990, and $US200 billion between 1991 and 1994 (see Table 2.2). The World Bank (1996) estimated that between 1985 and 1994 foreign direct investment doubled as a share of global GDP. This increase was fuelled by factors similar to those underlying the increase in Australia — a global trend towards deregulation and liberalisation of financial markets, which provided greater opportunities for investing offshore.

Figure 2.5: Flow and stock of ADIA relative to private domestic investment[a] and capital stock[b], 1960–61 to 1994–95 (per cent)



a Gross fixed capital expenditure on non-dwelling construction and equipment by the private sector.

b Private non-dwelling construction and equipment stock.

Note: Negative values of ADIA outflows are set at zero.

Sources: ABS, Cat. Nos. 5363.0, 5221.0 and 5204.0.

In 1994, the stock of world direct investment abroad stood at $US2378 billion, compared with $US514 billion in 1980.

Growth in ADIA relative to the growth in world FDI has varied over the last decade or so. In the first half of the 1980s, ADIA grew faster than world FDI. Subsequently, both Australian and global flows have fluctuated from year to year. However, average growth in world FDI has been higher than growth in ADIA.

In a submission responding to the draft report, Dr D. Bryan and Mr M. Rafferty contended that the very steep increase in ADIA and the subsequent rapid decline that occurred in the eight-year period to 1990–91 was out of step with international trends. They attributed this to factors unique to Australia, in particular the emergence of ‘new entrepreneurs’ in the mid-1980s and their capacity to establish substantial lines of credit. They said:

> ... the fact that Australian DIA [direct investment abroad] increased so quickly, and then fell so quickly, compared with other countries indicates that there was something distinctively Australian about the process. Our proposition is that the distinctiveness lay in the access to Eurofinance markets (and the changing way certain financial institutions raised and advanced capital). The takeover activity, domestically and internationally, followed directly (Sub. 36, p. 2).

Table 2.2: World outflows of foreign direct investment, 1976 to 1994 ($US billion, annual averages)

	1976–80	*1981–85*	*1986–90*	*1991–94*[a]
Industrial countries	39.0	41.4	158.6	176.3
United States	16.9	7.6	25.3	47.2
Japan	2.3	5.1	32.1	19.9
United Kingdom	7.8	9.2	28.1	22.9
Other Europe	10.0	15.1	63.9	78.7
Australia[b]	0.3	1.1	3.4	2.6
Developing countries[c]	0.8	1.8	9.1	23.4
Asia	0.1	1.1	7.8	19.8
Latin America	0.2	0.2	0.6	1.8
World outflows	**39.7**	**43.2**	**167.7**	**199.8**

a Data for 1994 are preliminary.
b IC estimates based on International Monetary Fund data.
c Including Eastern Europe.
Source: Bank for International Settlements 1995.

In the Commission’s view, it is not clear that the Australian experience has been substantially different from that of some other countries. For example, the surge in ADIA commenced in 1984 — the same year in which direct investment abroad by most OECD countries started to increase rapidly. Similarly, when ADIA started falling after 1988, some other OECD countries — such as the United Kingdom — also experienced a rapid and prolonged decline in outward direct investment (see OECD 1995a). Furthermore, the increased access to Euro-finance markets was not unique to Australia. While limited data are available, the available evidence indicates that the geographic and industry concentration of ADIA was also not unique to Australia.[2]

The majority of world FDI has come from industrialised countries, with the United States, Japan and United Kingdom accounting for around 45 per cent in recent years. Outflows from developing countries in Asia have grown rapidly during the 1990s. For instance, between 1991 and 1994, annual average FDI from developing Asian countries accounted for 10 per cent of world direct investment, compared with less than 5 per cent between 1986 and 1990.

Annual ADIA as a proportion of GDP was similar to the OECD average during the 1980s (see Table 2.3). However, during the 1990s, ADIA as a proportion of GDP was generally lower than the corresponding figure for the OECD as a whole. Some other relatively small economies, such as Belgium-Luxembourg, Switzerland, Sweden and New Zealand, have recorded significantly higher levels of direct investment abroad relative to GDP since the mid-1980s. In part, this could reflect the close proximity of those countries to relatively large markets with patterns of demand similar to those in their own domestic markets.

2.4 Characteristics of ADIA

This section outlines the main characteristics of ADIA in terms of the number of firms investing offshore and the form and location of their investments.

Number of firms

Higher levels of ADIA reflect, in part, an increase in the number of Australian firms involved in offshore activities. The number of Australian enterprises investing overseas nearly doubled between 1975–76 and 1991–92 (see Figure 2.6).[3] The number of overseas enterprises receiving investment from Australian enterprises exhibited similar movements. Data compiled by Ibis Business Information (see Thomas 1995) suggest that, in 1994, the largest 10 parent companies accounted for about 30 per cent of the total number of overseas subsidiaries.

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2 The outward direct investment stocks of OECD countries are concentrated in particular industries, such as finance, insurance and business services, and chemical products.

3 Little information is available about the characteristics of Australian firms that undertake ADIA. However, based on several past studies, Markusen (1995) suggested that multinationals are most prevalent in industries that have: high levels of research and development; workforces comprising a large proportion of professional and technical workers; products that are new and/or technically complex; and a high level of product differentiation and advertising.

Table 2.3: Outflows of direct investment as a percentage of GDP, selected OECD countries, 1981 to 1994 (percentage)

	1981–85	*1986–90*	*1991–94*
Belgium-Luxembourg[a]	0.2	2.5	3.2
Switzerland	1.3	2.7	2.5
United Kingdom	2.0	3.6	2.2
Sweden	1.4	4.3	1.9
New Zealand	0.7	1.8	1.5
France[a]	0.5	1.4	1.2
Canada[a]	0.9	1.1	1.0
Germany	0.6	1.1	0.9
United States	0.2	0.5	0.8
Australia	**0.6**	**1.6**	**0.7**
Japan[a]	0.4	1.2	0.5
OECD average[b]	**0.6**	**1.5**	**1.3**

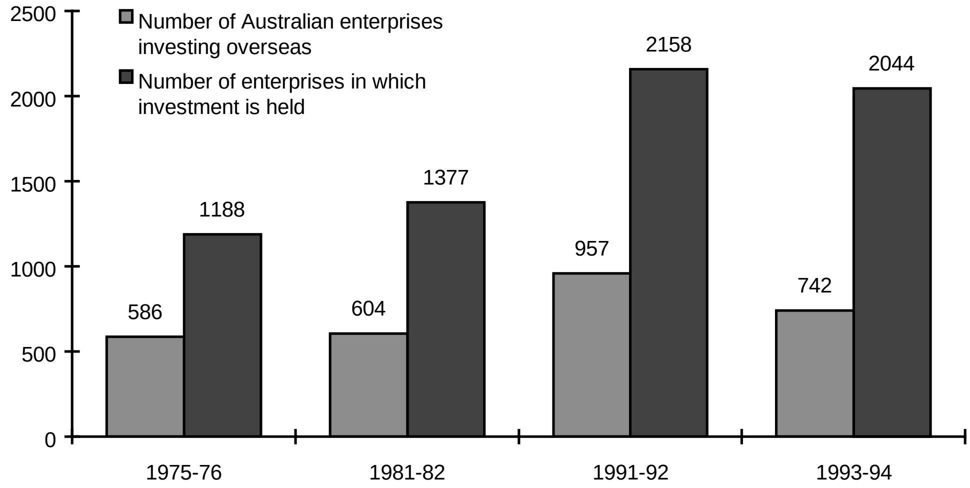
a Reinvested earnings are not included in official statistics.
b Average of 21 OECD countries. Greece, Ireland and Mexico are not included.
Source: OECD 1995a.

There is very little information about the activities of the overseas firms in which Australian firms have invested. However, information published by the United States Department of Commerce provides some insights about Australian-owned companies in the United States.[4] In 1993, such companies had total assets and sales of about $US48 billion and $US32 billion, respectively (see Table 2.4). The companies employed about 138 000 people and produced goods and services with an annual value of over $US8 billion. The companies served mainly the United States market, with merchandise exports comprising only a minor proportion of their total sales (2 per cent in 1993). In recent years, imports by those companies (including goods imported from Australia) have been around double the level of exports. In the four years

[4] Companies in which Australian residents own 10 per cent or more of the voting securities. The data are published only for non-bank affiliates. However, according to ABS data on ADIA, firms categorised as providing finance, property and business services — which include banks — account for less than 3 per cent of ADIA stock in the United States.

to 1993, the affiliates based in the United States recorded significant losses (totalling over $US4.4 billion).

Figure 2.6: Number of firms investing and receiving investment, 1975–76 to 1993–94



Source: BIE 1995a.

Australian offshore investment is often in the form of a joint venture. In many instances, this reflects advantages that are perceived to stem from having a ‘local’ partner. However, in some cases, especially in Asia, governments require that foreign investors form joint ventures with local partners. A recent survey of Australian investment in Asia (Westpac 1995, p. 15) reported that more than half of the investments made by 123 respondents had been in the form of joint ventures.

Form of investment

The form of investments made by Australian firms, although varying considerably from year to year, has comprised mainly reinvested overseas earnings and investment in corporate equities (that is, in companies incorporated in foreign countries). Over the four years to 1994–95, ADIA in unincorporated companies, joint ventures and partnerships (classified as net equity in branches in Table 2.5) represented a relatively small share of ADIA outflows. In some years (for example, 1991–92 and 1992–93), Australian parent companies borrowed more from their foreign subsidiaries than they lent to them.

Table 2.4: Characteristics of Australian non-bank affiliates[a] in the United States, 1990 to 1993

($US million, unless otherwise indicated)	1990	1991	1992	1993
Total assets	46 073	48 413	45 900	47 965
Sales	31 738	33 897	30 817	31 925
Gross product	8 096	8 809	8 101	8 145
Net income	-875	-1 459	-1 129	-949
Employee compensation	6 376	6 567	6 471	6 203
Gross property, plant & equipment	21 612	21 055	13 803	14 843
Expenditures for new plant & equipment	4 047	2 087	1 074	1 809
US merchandise exports shipped by affiliates	491	845	734	715
US mechanise imports shipped to affiliates	846	1 493	1 432	1 408
Employment (thousands of employees)	166	155	138	138

a Non-bank US companies in which Australian residents own 10 per cent or more of voting securities.
Sources: US Department of Commerce, Bureau of Economic Analysis (various years).

Table 2.5: Form of ADIA outflows[a], 1991–92 to 1994–95 ($ million)

	Reinvested earnings	*Corporate equities*	*Net equity in branches*	*Lending*	*Other*	*Total*
1991–92	555	948	101	-124	-88	1 393
1992–93	2 045	1 740	777	-1 878	159	2 844
1993–94	2 434	1 626	673	1 568	22	6 323
1994–95	3 866	128	119	926	-329	4 709

a ADIA data are compiled on the basis of netting out the transactions between the Australian parent companies and their subsidiaries abroad. A negative value in net equities, for example, implies a withdrawal of foreign assets. A negative value in the ‘lending’ category means that Australian parent companies borrowed more from their subsidiaries than they lent to them in that year.
Source: ABS, Cat. No. 5363.0.

Destinations of ADIA

The available data on the destinations and sectoral patterns of ADIA are subject to a number of caveats.

- First, due to significant fluctuations in ADIA flows, annual flow data are not particularly meaningful.
- Second, statistics on destinations and industry composition relate to countries and industries to which Australian investment is initially directed. In some circumstances, these may differ from the countries and industries where the funds are finally used.[5]
- Third, for reasons of confidentiality, only limited data classified by industry and country of destination are published.

For these reasons, it is not possible to obtain a precise picture of the location of Australian international investment activities.

Countries receiving ADIA

The bulk of ADIA is directed to English-speaking, developed countries (see Figure 2.7). For example, in 1994–95, 80 per cent of the accumulated stock of ADIA was invested in the United Kingdom, the United States and New Zealand. The geographical dispersion of ADIA in that year was the outcome of quite sizeable shifts in the pattern of ADIA since the late 1970s.

The major change has been the large increase in ADIA in the United Kingdom. Between 1979–80 and 1994–95, the United Kingdom's share of Australian offshore investment trebled from 12 per cent to 39 per cent.

In contrast to this increase, the proportion of ADIA stock in ASEAN countries has fallen. In 1979–80, ASEAN countries accounted for 28 per cent of the stock of ADIA (see Figure 2.8). However, ADIA in ASEAN countries fell sharply between 1981–82 and 1985–86 (that is, there were net withdrawals of ADIA). At the same time, ADIA in the United States, the United Kingdom and New Zealand increased. As a result, the share of the stock of ADIA held in the latter countries increased, and the share in ASEAN countries dropped to around 2 per cent.

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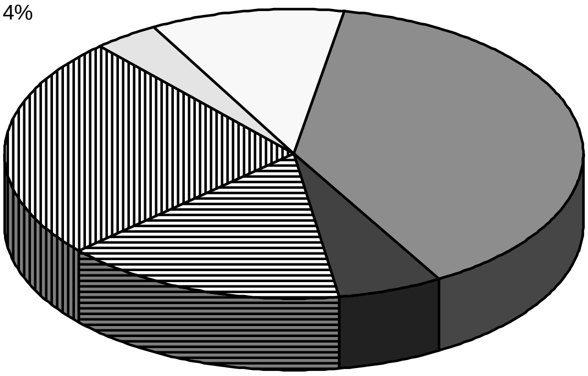
5 A recent ABS study commissioned by the Department of Foreign Affairs and Trade showed that, in terms of equity investments, ADIA in the United Kingdom, the United States and New Zealand has remained largely within those countries. But around 20 per cent of ADIA in some Asian countries is diverted elsewhere (mainly to other Asian countries) (see Sturgiss 1995).

Figure 2.7: Distribution of ADIA stock in 1994–95 (per cent)



Source: ABS, Cat. No. 5352.0.

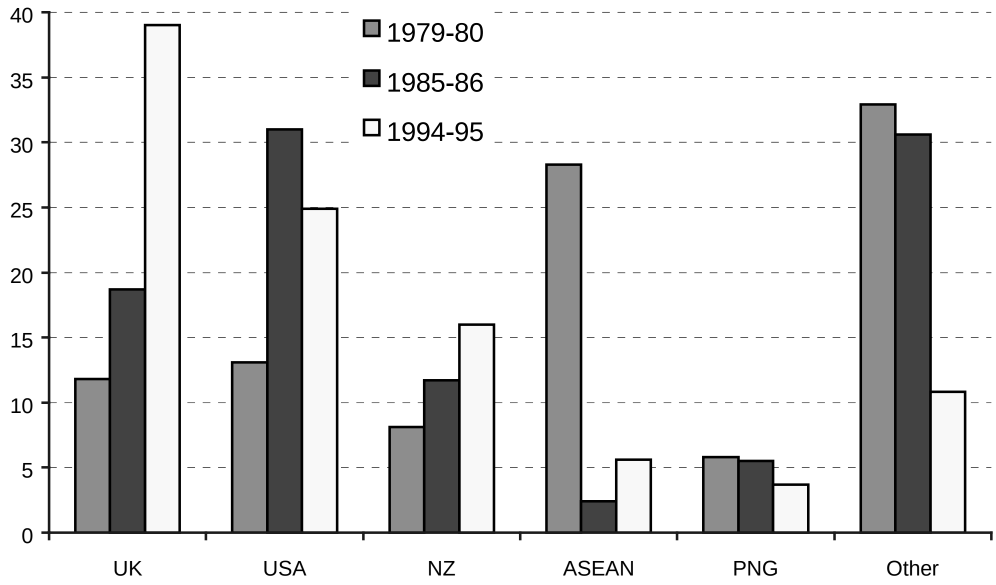
Between 1985–86 and 1992–93, the share of ADIA stocks held in ASEAN increased steadily again to 8 per cent, before falling to 6 per cent in 1994–95, well below that invested in the United Kingdom (39 per cent), the United States (25 per cent) and New Zealand (16 per cent).

Apart from the significant decline in the share of ADIA held in ASEAN countries, the share of ADIA directed to ‘other’ countries has also fallen since the late 1980s. Falling ADIA in Central America, the Caribbean and Hong Kong has contributed significantly to this decline.

Largely because of the declining proportion of ADIA in ASEAN countries, the stock of ADIA in APEC countries as a proportion of the total ADIA stock has fallen. Nonetheless, in 1994–95, around 53 per cent of the total ADIA stock was in APEC countries.

The concentration of ADIA in English-speaking countries reflects a number of commercial and non-economic factors. A common explanation is that familiarity with the culture, language, history and with the political and legal systems has encouraged ADIA in those countries. The relatively large size of the domestic market in those countries and the need to obtain access to regional trading arrangements in Europe and North America also may have influenced the investment decisions of Australian firms.

Figure 2.8: Stock of ADIA, by country and region, selected years (per cent of total stock)



Source: ABS, Cat. No. 5352.0.

The BIE (1995f) cited several reasons for the decline in the share of ASEAN in ADIA. These include:

- a slowdown in ASEAN economic growth in the first half of the 1980s;
- a more accurate perception of the risks associated with direct investment in ASEAN countries;
- 'bad' experiences of some companies investing in the region; and
- a better appreciation of the impediments to ADIA (such as restrictions on foreign investment and repatriation of profits, poor quality business infrastructure and poor enforcement of intellectual property rights) in some ASEAN countries relative to alternative locations.

The fall in the share of ADIA held in ASEAN countries could also reflect the timing and pace of liberalisation in ASEAN countries relative to other countries. Significant reforms were undertaken in OECD countries during the first half of the 1980s. Although there was also reform in ASEAN countries during this period, the main impetus for reform was in the late 1980s.

The share of ADIA directed to Asia is not unusually low by comparison with other OECD countries. Indeed, the most recent available data indicate that the share of ADIA directed to Asia is higher than for all other OECD countries except Japan (Sturgiss 1995). For example, in 1993, 10 per cent of ADIA stock was invested in Asia, while only 7 per cent of direct investment from the United States and United Kingdom was held in Asia. Nonetheless, Australia's proximity to, and relatively high level of trade with, Asia might suggest that ADIA in the region would be higher. For example, OECD countries' trade with Asia, as a proportion of their total trade, is generally much lower than Australia's.[6] The fact that Australia's exports comprise a high proportion of commodities relative to most other OECD countries may help to explain why the ratio of ADIA to trade in Asia is not higher.

The broad geographical pattern of Australian investment is also consistent with OECD trends. For example, most OECD outward investment is directed to member countries. According to the OECD, on average only 17 per cent of the stock of outward direct investment of the 10 largest investing countries was in non-OECD member countries in 1993. The OECD (1995a) said:

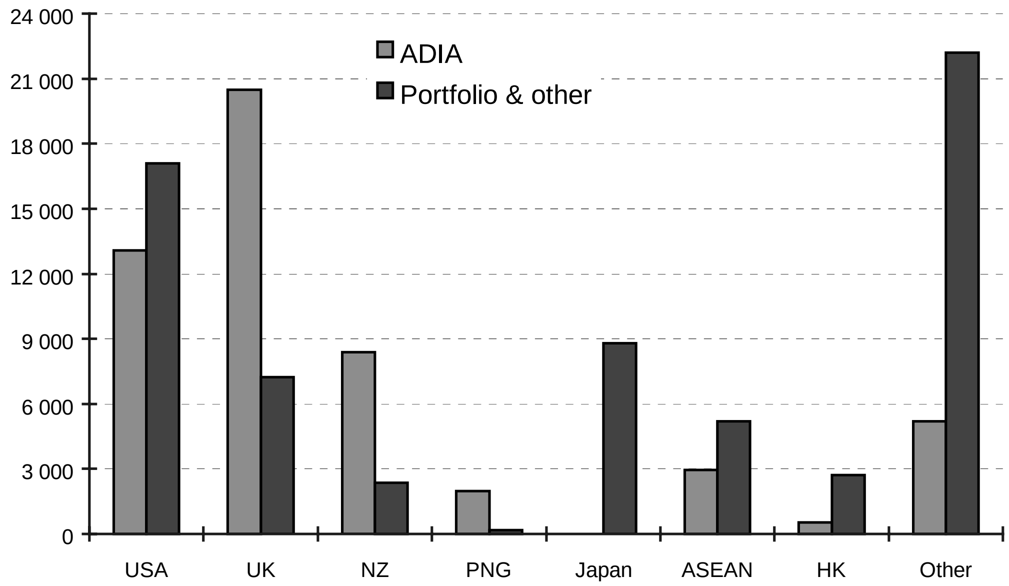
> In spite of the attention on global strategies of firms, the evidence suggests that a significant share of FDI flows remains within the region of the investor. When a firm does look beyond its own region, it is more likely to be attracted by the size and growth prospects of the host market than by opportunities for exporting back home. There is little evidence of a shift in capacity away from OECD countries towards the non-OECD area. Indeed, there is even a growing volume of investment by firms from certain non-OECD countries into the OECD economies (pp. 11-12).

In 1994–95, approximately 14 per cent of the stock of ADIA was located in non-OECD member countries.

To some extent, the focus on ADIA disguises substantial differences in the pattern of total Australian investment abroad. For instance, while the stock of ADIA in Japan has been small, Australian portfolio and other non-official investment has been substantial ($8.8 billion in 1994–95) (see Figure 2.9). Similarly, portfolio and other non-official investment in the United States, Hong Kong, ASEAN countries and other countries not specifically identified in Figure 2.9 outweighs ADIA in these countries.

6 According to Sturgiss (1995), in 1993 about 38 per cent of Australia's exports were to Asia (excluding Japan). Japanese exports to Asia were also equivalent to 38 per cent of its aggregate exports. However, the corresponding shares for the other countries ranged from 18 per cent (in the case of the United States) to 4 per cent (Canada).

Figure 2.9: Stock of ADIA and portfolio and other investments, by country, 1994–95
($ million)



Source: ABS, Cat. No. 5363.0.

While official data are not available for Asia as a whole, recent ABS statistics indicated that ADIA in ASEAN countries increased by 5 per cent in 1994–95, with significant growth in Indonesia. During industry visits, many companies indicated that they have recently invested in, or are currently planning new investment in, Asia (particularly in Indonesia). Higher levels of investment in the region are supported by a BIE survey (1995f). It reported that future growth in ADIA is forecast to be greatest in Asia.

A more recent survey (Pacific Power and Access Economics 1996) of new overseas projects involving Australian firms (projects ‘under construction’, ‘committed’, and ‘under consideration’) found that 57 per cent of the total value of new overseas projects is in Asia (excluding Papua New Guinea). Projects categorised as ‘mining’ and ‘power and water’ accounted for most of the new investment in Asia (15 per cent and 53 per cent, respectively). The total value of new overseas projects covered by the survey was around $56 billion (including non-Australian equity investments).

Sectoral and industry composition of ADIA

In the 1960s, most ADIA was in mining and manufacturing activities. However, since the mid-1970s, most ADIA has been in service sector activities. In 1994–95, the service sector accounted for 48 per cent of ADIA stock; ADIA in manufacturing and mining represented around 38 and 14 per cent of the stock, respectively (see Table 2.6).

Table 2.6: Change in sectoral composition of ADIA

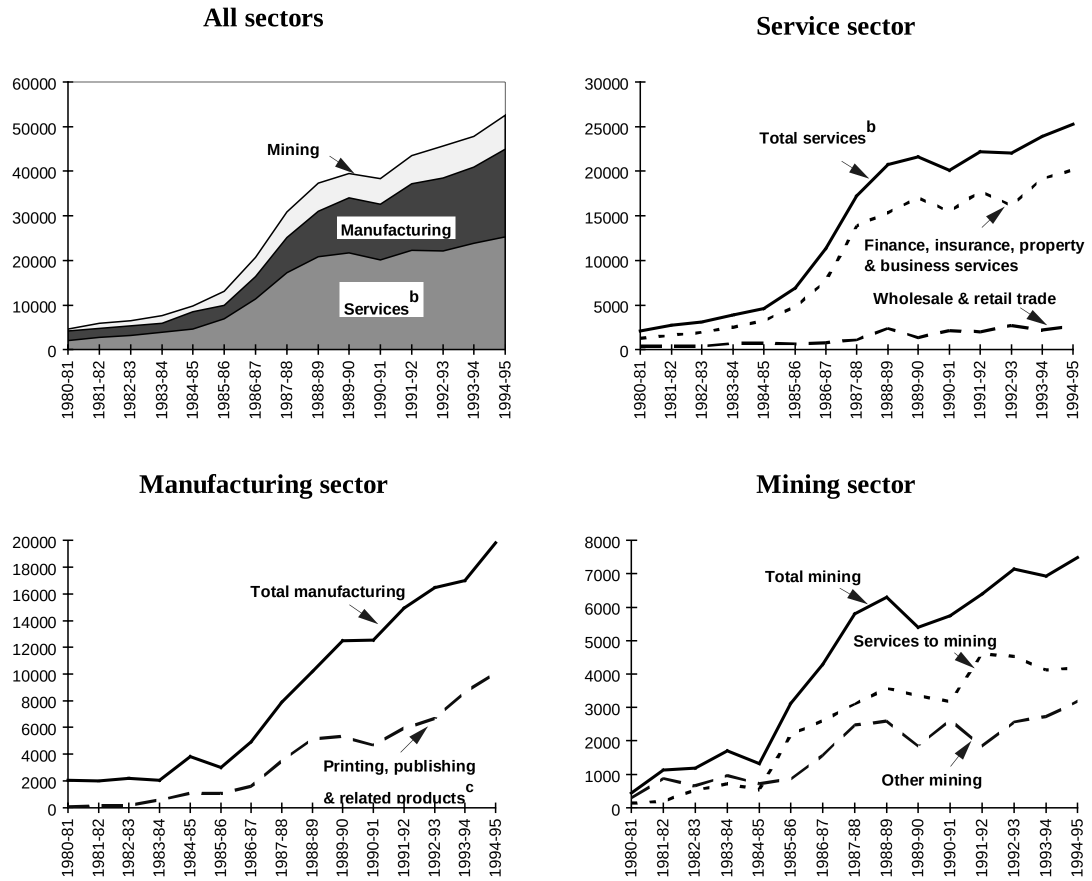
Sector/industry	*Increase in stock between 1985–86 and 1994–95*		*Sectoral composition at end of 1994–95*	
	($m)	*(% of total increase)*	*($m)*	*(% of ADIA stock)*
Mining	**4 364**	**11.1**	**7 481**	**14.3**
Services to mining	2 001	5.1	4 189	8.0
Manufacturing	**16 775**	**42.5**	**19 786**	**37.7**
Printing, publishing & related products[a]	8 984	22.8	10 033	19.1
Services[b]	**18 336**	**46.4**	**25 225**	**48.1**
Finance, insurance, property & business services	15 360	38.9	20 129	38.3
Wholesale & retail trade	2 027	5.1	2 660	5.1
Total all sectors	**39 474**	**100.0**	**52 492**	**100.0**

a Mainly printing, publishing, recorded media.
b Includes a minor contribution from agriculture and unallocated industries.
Source: ABS, Cat. No. 5363.0.

A feature of ADIA during the 1980s and 1990s was the increase in investment in all sectors, particularly since 1985–86 (see Figure 2.10). However, since 1985–86, increases of ADIA in services and manufacturing have contributed most to the growth in ADIA stock. Between 1985–86 and 1994–95, the ADIA stock increased by nearly $40 billion, of which 46 and 43 per cent were contributed by the service and manufacturing sectors, respectively.

The predominance of services in Australian offshore investment reflects the specific characteristics of services. As discussed in the next chapter, production and consumption typically need to occur at the same location. In retail banking, for instance, the effective delivery of most services to foreign customers requires a permanent presence in foreign countries. Thus, the option of exporting from Australia which is available to many manufacturing firms is not available for many service providers.

Figure 2.10: Stock of ADIA, by sector and selected industries, 1980–81 to 1994–95[a] ($ million)



a Data before 1989–90 are based on the ASIC system. Data since 1989–90 are classified on the ANZSIC basis.

b Include agriculture and unallocated industries.

c Mainly printing, publishing and recorded media.

Sources: ABS, Cat. No. 5363.0 and 5352.0.

At the industry level, the limited data available reveal that ADIA in finance, insurance, property and business services has accounted for the largest share of Australian offshore investment, representing 38 per cent of total ADIA stock and 80 per cent of service sector ADIA stock. Wholesale and retail trade has also become increasingly important. In 1994–95, it represented about 11 per cent of service sector investments and 5 per cent of the accumulated value of all ADIA.

About one-half of ADIA in the manufacturing sector comprises investment in printing, publishing and recorded media. Investments in these areas now represent about 19 per cent of the total value of ADIA. There is also significant ADIA in petroleum, coal, chemical and associated products, which accounts for 14 per cent of manufacturing investment and 5 per cent of ADIA stock. Other prominent features of ADIA at the sector and industry level are shown in Box 2.1.

Box 2.1: Distribution of ADIA by country and industry

Stock data showing the sectoral and industrial composition of Australian investment are only published for a limited number of industries within the countries/regions receiving most Australian investment. The data, which show considerable variation between countries (see Appendix B, Table B.8), reveal that:

- ADIA in the United Kingdom is mainly in finance, insurance, property and business services (56 per cent);
- in contrast, ADIA in the United States is directed mainly to manufacturing activities (49 per cent) and mining (41 per cent);
- ADIA in New Zealand is predominantly directed to the service sector (74 per cent), mostly in finance, insurance, property and business services;
- over half of ADIA in the ASEAN countries is in manufacturing activities, mostly in petroleum, coal, chemicals and associated products. The bulk of the remainder is in the service sector, mainly finance, insurance, property and business service activities;
- mining activity is the predominant form of ADIA in Papua New Guinea;
- nearly two-thirds of ADIA in the Netherlands is in finance, insurance, property and business services; and
- almost all of ADIA in Hong Kong is in the service sector, mainly in finance, insurance, property and business services.

ADIA is also concentrated in specific industries. For instance:

- printing, publishing and recorded media account over 50 per cent of manufacturing sector ADIA in the regions covered by the data. While ADIA data for this industry are not published by country of destination, the Commission estimates that almost all is located in the United Kingdom (70 per cent) and the United States (25 per cent); and
- in the service sector, finance, insurance, property and business services account for around 80 per cent of ADIA.

Source: ABS, Cat. No. 5352.0.

Summing up

There has been a distinct increase in ADIA since the early 1980s. This is broadly consistent with global increases in foreign direct investment following the relaxation of restrictions on inward capital flows by many overseas governments.

ADIA now represents a sizeable proportion of total Australian investment abroad. While the flow of ADIA has increased relative to GDP and private domestic investment, it remains relatively small. ADIA is also smaller than direct investment in Australia by foreigners, although this gap has narrowed appreciably in recent years.

ADIA does not appear to have generated a high rate of profitability over the past decade, but firms expect this to improve. The bulk of ADIA income has generally been retained by the offshore enterprises.

Service sector activities (mainly in finance, insurance, property and business services) account for about half of the stock of ADIA.

The increase in ADIA has raised its economic importance. However, the limited data available hamper analysis of its implications. The Commission considers that the ABS should proceed to investigate the efficacy of extending the present data collection.

3 REASONS WHY FIRMS INVEST OFFSHORE

3.1 Introduction

The increases in Australian and global foreign direct investment over the last decade largely reflect increased opportunities for firms to establish offshore operations. The expansion has been facilitated by technological changes, such as improved communication systems, which have reduced significantly the costs of operating businesses in other countries and by the liberalisation of restrictions on international capital movements. Closer integration of world markets and greater uniformity in patterns of demand between countries also have promoted higher levels of foreign direct investment.

However, simply observing that greater investment opportunities have emerged sheds little light on a number of fundamental issues which need to be understood in order to identify any underlying policy implications. In this context, key questions include:

- what provides the offshore operations of firms the capacity to be competitive with local firms in the face of inherent disadvantages associated with operating in foreign countries?
- why do some firms choose to exploit overseas markets by establishing offshore operations rather than by supplying them through other means (for example, by exporting or by entering into licensing or other arrangements with indigenous firms)?
- what do firms consider to be the major 'drivers' underlying their decisions to use their competitive advantage to invest offshore?

In considering these matters, this chapter draws extensively upon information provided to the Commission in written submissions and informal meetings, and on data collected in various surveys, including a Commission survey of some 150 firms in the mining, manufacturing and service sectors. That information highlights substantial variation in the motives which underlie firms' decisions to invest offshore. The motives vary according to a diverse range of factors relating to the circumstances of individual firms, the nature of their products, the characteristics of their markets, economic conditions in both domestic and overseas markets, and the policies adopted by home and host governments.

The rest of this chapter provides a brief overview of these influences. To give some sense of their relative importance, it summarises the evidence provided by surveys and other studies, and provides some corroborative evidence from participants. From a public policy perspective, those factors which are subject to the influence of government are of particular interest. Consequently, these issues are examined in more detail in later chapters.

3.2 What makes offshore operations competitive?

Foreign firms can generally be expected to be at a disadvantage in establishing operations in overseas markets. Local firms typically possess better information about local market conditions and have a greater understanding of business practices in their own country (such as detailed knowledge of the business culture, the language, politics, law and local customs). The costs of acquiring this information for a foreign company can be high (see, for example, Hymer 1976). Offshore enterprises are also likely to encounter additional costs, such as those associated with transporting staff to and from the home country and stationing personnel overseas. In addition, they may be disadvantaged by local discrimination exercised by governments and consumers (for example, through purchasing schemes which favour locally-owned businesses).

It follows that to be successful in competing with local companies, foreign firms require some offsetting advantages. Markusen (1995) concluded that:

> If foreign multinational enterprises are exactly identical to domestic firms, they will not find it profitable to enter the domestic market ... the multinational enterprise must, therefore, arise due to the fact that it possesses some special advantage such as superior technology or lower costs due to scale economies (p. 173).

Key role of 'firm-specific assets'

A number of studies point to the importance of 'firm-specific assets' in providing firms with the competitive advantage required to compete successfully in overseas countries. These can be derived from a variety of sources. One is the exclusive ownership of intellectual property (such as a patent over a new product or process, or possession of a well known brand name or trademark). Another category includes intangible assets such as specialised management knowledge or marketing expertise. For example, Pioneer told the Commission that it competes successfully offshore in relatively low technology industries by capitalising on its operational, marketing and management skills:

> [Pioneer] has been able to transfer these skills into its overseas businesses through the assignment of Australian managers and supervisors, and the application of engineering, systems and processes from its Australian operations (Sub. 4, p. 5).

According to Markusen (1995), these stocks of intangible assets can be characterised as ‘knowledge capital’. He noted that multinationals are prevalent in industries in which such intangible, firm-specific assets are important. Graham and Krugman (1993) concluded that multinationals are disproportionately concentrated in sectors with large R&D budgets, in part because of the transaction costs involved in selling and licensing technology.

A BIE study surveyed 45 Australian multinational corporations engaged in manufacturing or service sector activities about their sources of competitive advantage (BIE 1995f). The responses revealed that the most valued assets identified by manufacturing and service sector enterprises were superior management and staff, and ‘own technology’ (technology developed by the firm).

In this inquiry, CRA told the Commission that it had grappled with the question of how to manage a large organisation in the 1990s, and had invested heavily in developing new management systems and organisational structures (including horizontal and vertical relationships, and rights and lines of accountability). It has been able to capitalise on these in each new business it developed, whether in Australia or offshore.

In some instances, a firm’s advantage springs from its ability to produce and sell new or differentiated products (for example, Coca Cola and Hardiplank), or to produce existing products more cheaply or with improved quality. These advantages often are developed through long-term investments in R&D, education and training, and the successful application of the developed skills and technologies.

In this context, the Commission was told that Pacific Dunlop invests in offshore operations only after it has developed the appropriate skills and technologies. Similarly, Tubemakers said that its technology and R&D were the keys to its success, while Burns Philp (1994) claimed that R&D is a cornerstone of its growth as an international food company:

> Our growth is heavily dependent on our internationally recognised skills in both research and development and process technology. The company’s world class yeast technology remains the centrepiece of the research and development program (p. 7).

Reflecting this, new investments for Burns Philp generally involve proprietorial equipment and technology, as in its recent investment in Brazil. Much of this is produced domestically: Australia is still the main centre for the company's R&D.

Firm-specific assets exhibit some of the characteristics of a 'public good' (within the confines of the firm) in the sense that, once a firm has obtained these assets, they can be applied to other production facilities at low cost. Hence, any advantage embodied in knowledge, information or technique which yields positive returns in the first market can potentially also be exploited successfully in new markets without incurring again the costs associated with the initial discovery. In Caves' (1971) view, this public good characteristic of firm-specific assets is an important prerequisite for direct investment abroad. However, by itself, it is insufficient to explain offshore investment decisions:

> ... the firm investing abroad must not only enjoy enough of an information advantage in its special asset to offset the information disadvantage of its alien status; it must also find production abroad preferable to any other means of extracting this rent from a foreign market, such as exporting or licensing an established native producer (p. 5).

3.3 Alternative means of supplying overseas markets

Provided that the benefits derived from ownership advantages are sufficient to outweigh the cost penalties incurred when competing against local enterprises in their domestic markets, firms have the opportunity to establish viable offshore facilities. However, this option needs to be evaluated against alternative means of supplying or servicing the foreign market, such as exporting or licensing production of the good or service to a local enterprise.[1]

Exporting versus overseas production

The choice of location of production hinges on relative profitability (which can be influenced by a wide range of factors — see Box 3.1). The expected return from establishing an offshore plant, in addition to meeting the firm's 'hurdle' rate of return, would need to exceed that from exporting or having the good or service supplied by a licensed overseas producer.

[1] Depending on the nature of the ownership advantage, it may also be possible to sell or lease the asset from which the advantage stems.

Box 3.1: Why CRA is in Indonesia

CRA has maintained an active presence in the Indonesian mining sector for 25 years, and is Australia's largest single investor in Indonesia. It currently has two large mining operations in Indonesia — Kaltim Prima Coal and Kelian Equatorial Mining. CRA said that Indonesia's attractiveness as an investment destination for the company is based on:

- high prospectivity for gold, copper, nickel and coal;
- a strong desire on the part of the national government to encourage (foreign) mining investment, which is regarded as a key contributor to economic growth and an important source of income and employment for communities in remote locations;
- a stable political climate; and
- a regulatory system that provides certainty for mining investment, which typically requires large capital expenditure commitments and long development periods.

Major mining developments in Indonesia are governed by 'contracts of work'. These are comprehensive agreements with the Indonesian Government, covering all aspects of the investment from exploration through to project development and mine operations. CRA said that they provide "fiscal and legal certainty", and can be negotiated for periods sufficient to cover the expected duration of the mining operation.

Source: Sub. 13, pp. 21-2.

In assessing whether or not it is preferable to produce abroad, the expected profitability of the new venture will normally be a major factor, but not the only consideration. Account also needs to be taken of other direct benefits that may accrue to home country operations (for example, higher production of components for use in the offshore plant) and other 'spin-offs' that could benefit the firm as a whole (for example, increased awareness of new technologies and emerging market trends).

Greater exposure to international competition can also increase the incentives to innovate and to adapt products and marketing methods to better meet users' needs. For instance, James Hardie suggested that Australian firms can learn to improve their competitiveness in the domestic market by engaging in competition overseas, while Wattyl said it benefited from operating in the United States, where most paint industry R&D takes place. Indeed, several participants put the view that the more intense competition experienced by their offshore businesses provides additional impetus for improving the efficiency of their domestic operations, which are increasingly open to international competition.

The nature of the product itself may preclude exporting and require a firm to invest offshore if it seeks to tap into foreign markets. As noted in the previous chapter, a large share of ADIA is in services, many of which are physically non-tradeable. For example, in the context of electricity provision, BHP said that:

> If we are to supply those markets [Asia and Latin America], we have to locate our production facilities there for the obvious reason that electricity can't be transported inter-continentally (Sub. 15, p. 8).

Other products are simply very expensive to trade. For example, some manufactured goods are physically tradeable but uneconomic to export. Examples include some building materials, which are prohibitively expensive to ship because of their bulk, non-standard shape or fragility. Typically, it is more economical to produce such goods close to where they are used, allowing firms to avoid direct land transport costs to the port, shipping and related insurance costs. Similarly, given the relatively high cost of exporting soft drinks, Coca Cola-Amatil has invested in production facilities in many countries including Poland, the Ukraine and Belarus in recent years. Likewise, Pioneer's high volume and low value quarry products need to be produced close to markets. BHP indicated that transport costs are also relevant to mining sector investment decisions. It said:

> While Australia is well located for access to the fast growing Asian markets, it is not so well situated for access to European and Eastern United States markets, for which mines in South America or Africa have a freight advantage (Sub. 15, p. 4).

High freight charges associated with the shipment of bulky, relatively low value goods are exacerbated by inefficiencies on Australia's waterfront. A study by the BIE (1995d) found that waterfront charges in Australia are higher, and the productivity of stevedoring is lower, than in most of the ports surveyed in New Zealand, Asia and Europe (see Chapter 9).

The significance of tradeability as the primary influence on a firm's investment decisions was confirmed in a study by Yetton, Davis and Swan (1992). The study cited international research which suggested that, while the proportion of sales made overseas is broadly constant across industries, the mix between exports and offshore production depends upon the degree of tradeability of the goods and services produced:

> Exports ... move to increasingly lower levels as tradeability declines, and are dominated by foreign production at the lower traded end (p. 60).

For many firms, the relative merits of locating offshore compared with exporting will depend on the expected volume of overseas sales. In this context, several firms said that, in the early market development stage, it is frequently more efficient to supply a market by exporting from Australia. However, as sales volumes increase, it often becomes more advantageous to establish offshore production facilities. For example, Pacific BBA said that:

> If export volumes continue to grow there may be pressure to manufacture closer to the customer base (Sub. 1, p. 2).

Similarly, several Australian companies now operating in the United Kingdom said that they had served that market originally by exporting, but had found it commercially sensible to produce locally when their market reached a particular size (see Edwards and Buckley 1995). The Commission also was told that many firms which invest overseas initially test the market by exporting. If their products gain sufficient recognition in the host market, it then becomes profitable to produce in those markets.

In those instances where it is possible to produce either at home or abroad, decisions about the location of new investments will be influenced by a range of factors that impinge on the cost of producing the goods or services in question. These factors include raw material costs, labour costs and transport costs, as well as impediments and incentives which are subject to control by governments (for example, trade barriers and foreign tax concessions). The role of these factors is discussed later in this chapter.

Offshore production versus licensing or selling technology

If it is decided that offshore production, rather than exporting, is appropriate, a firm must then choose between retaining control of those assets which give it a competitive edge by establishing its own offshore facilities or, alternatively, entering into a licensing agreement with (or selling the ownership rights to) a local producer. A major determining factor will be the nature of the firm-specific assets. The firm will need to consider a number of potential benefits and costs. These include:

- if the specialised asset is knowledge-related, the rate at which it will be diffused to competitors under each option. For example, the diffusion of knowledge to existing and potential competitors may be slower if the firm establishes its own subsidiary rather than selling such ‘rights’ under a licensing agreement;
- the transaction costs incurred in formalising arrangements with the licensee compared with the costs of establishing offshore operations;[2]
- the cost of monitoring operations performed by a licensee;

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[2] Typically, these include the search costs of identifying buyers, time and resources spent on negotiation of terms and conditions and contract preparation and enforcement.

- the cost of transferring ownership assets, particularly those which involve knowledge-intensive technology. More specifically, it may be difficult and costly for the firm to transfer management or technical skills which depend on the individual skills of a small number of executives; and
- considerations relating to economies of scale and scope for both domestic and offshore operations.

The relative significance of these factors will vary among firms, products and countries. Within the economics literature, much attention has focused on the value which firms place on protecting firm-specific advantages which are knowledge-based, highlighting a concern that licensing will facilitate the transfer of the specialist knowledge to competitors. On these grounds, some argue that licensing can rarely be warranted if it involves firm-specific knowledge. For example, Rugman (1986) claimed that:

> Only when the product incorporating the knowledge becomes standardised, or when technology is not itself the source of an advantage, is it feasible that the risk of dissipation will be low enough [for licensing to be viable] (p. 105).

Markusen (1995) pointed out that, in the process of negotiating with a potential licensee, a firm may not wish to disclose too much about its technology. On the other hand, a licensee may not be willing to proceed without detailed knowledge of the assets involved. In such circumstances, it may be difficult for licensing arrangements to be concluded.

Dunning (1989) argued that, as a rule, firms prefer to internalise competitive advantages which are firm-specific because they:

> ... perceive that by internalising the market for these rights they are more likely to secure the full economic benefits from them (p. 49).

Bollard and Cremer (1995) considered internalisation to be a strong force driving foreign direct investment activities when it comes to protecting technological superiority and the capability to generate new technological knowledge through R&D. In their view:

> ... by internalising a productive asset in a foreign location, the firm is able to keep the property rights to ... information, whereas this cannot be done as effectively by exporting, licensing or sub-contracting.

They concluded that:

> ... [the] *theory of internalisation* is therefore a theory specific to foreign direct investment (p. 18).

While early theories of FDI tended to focus upon the effects of differential rates of return on capital flows, more recent work has a greater firm-specific focus. For example, in studies which developed an 'eclectic' analytical framework, Dunning (1977, 1988) suggested that the advantages of internalisation are one of three preconditions needed to justify investment in offshore facilities as the preferred way of participating in overseas markets. The other two preconditions have been touched on earlier. They are, first, the possession of assets from which a firm can gain an ownership advantage and, second, locational advantages which make it more profitable to locate production overseas rather than to supply from the domestic base. Together they have become known as the OLI (ownership, location and internalisation) framework.

The way in which these firm and product characteristics, which create the capacity for offshore investment, are brought to bear in actual decisions about direct investment in overseas countries is influenced by a number of factors. The following section discusses in some detail the most important of these factors.

3.4 Influences on firms' decisions to locate offshore

While firms' decisions to locate offshore are driven ultimately by expectations of achieving higher returns than from alternative investments, this assessment can generally be traced back to one, or a small number, of key factors which are crucial to the success of the venture. These vary considerably among firms, depending mainly on the nature of the good or service and conditions in the host country compared with those in the home country.

It is possible to categorise the factors expected to underlie the success of offshore ventures in a number of different ways. For example, they could simply be considered as either *'pull' factors* — those which attract Australian firms to overseas markets (such as favourable market growth prospects or tax concessions) — or *'push' factors* — those which are perceived to impose relatively high costs on locally-based firms (for example, the costs incurred in complying with domestic regulations) and which encourage Australian firms to locate offshore. However, classification into two broad categories masks a considerable diversity of factors within each group. Consequently, for the purpose of this report, a more detailed classification has been adopted. This involves four separate categories:

- *market demand-oriented influences* which encompass factors relating to both the domestic market (for example, lack of growth opportunities) and the host country market (for example, the benefits of locating in close proximity to end users);
- *the cost and availability of inputs* such as raw materials and labour;

- *host government influences* which are mostly ‘pull’ factors such as financial incentives and trade barriers, but can also include barriers to Australian investment abroad (‘stop’ factors) — examples include foreign ownership limits, local content provisions and requirements to meet minimum export targets; and
- *home government influences* which are mainly ‘push’ factors such as regulatory measures perceived to disadvantage firms located in Australia compared with those located offshore (for example, labour or land access requirements), but also can include domestic policies (‘stop’ factors) which deter offshore investment (such as industry protection or investment incentives).

Participants’ submissions and the Commission’s discussions with a wide range of Australian firms with offshore operations suggest that offshore investment decisions often are driven not by one factor, but by a combination of factors (see Box 3.2). Nonetheless, the key factors underlying offshore investment decisions (other than in the mining sector) are market demand-related. Advantages stemming from being located close to customers and being better placed to exploit growth opportunities in overseas markets are seen as particularly important. These are discussed in detail in the next section.

The major role attributed to market demand influences is consistent with the findings of a number of Australian and overseas studies (see, for example, UN 1992) as well as various surveys (see Box 3.3 and Appendix C). For example, during 1994–95, the United Kingdom’s Department of Trade and Industry (DTI) undertook a major study on outward direct investment which involved a survey of 900 firms, including both exporters and investors. The study concluded that market expansion and development is the overwhelming driver of outward investment of United Kingdom firms, whether small or large, in both service and manufacturing sectors. The potential for reducing costs (including labour costs) was not a major factor for the vast majority of investment projects (DTI 1996).

Box 3.2: What motivates Pioneer to invest offshore?

Pioneer, which commenced business in 1949 with one concrete plant in Sydney, is now one of the world's largest suppliers of building materials, and the second largest producer of pre-mixed concrete. The group operates over 550 concrete plants and 115 sand, aggregate and hard rock quarries in 16 countries. Pioneer has approximately 9000 employees and 5000 contractors around the world, of whom 3400 employees and 1200 contractors are based in Australia.

Pioneer cited the following reasons for locating its operations overseas:

- Because the industry is dominated by only a few companies, the scope for a significant increase in market share in Australia is limited by the Trade Practices Act.
- Export potential is limited because most of its products are not readily exportable (for example, its quarry products are high volume and low value, and pre-mixed concrete cannot be transported far) and high import tariffs apply in Asia.
- Pioneer is competitive offshore. It has generally been able to win market share in selected markets through its operational and marketing experience, superior costs, supply reliability and product quality.
- The potential market size and growth rates for building materials in other countries are substantially higher than in Australia. For example, the pre-mixed concrete market is 12 times larger in the United States than in Australia.

In determining where to invest, Pioneer assesses each country against a number of broad criteria. These are: macroeconomic and demographic attractiveness (GDP and population growth, country risk and business environment); product market attractiveness (market size and growth, building industry maturity and building material company profitability); and market competitiveness/regulation characteristics (competitive intensity in key products, Pioneer's ability to compete, government control/regulation and vulnerability to failure).

Source: Sub. 4.

Comments made by participants supported the significance of market demand-oriented influences. For example, the Business Council of Australia agreed that "there are many market demand-oriented influences pulling investment by Australian companies offshore" (Sub. 35, p. 3).

In its survey of 35 manufacturing and 10 service sector firms, the BIE (1995f) found that 'market-based' factors provided the most important broad motivation "by a substantial margin". It found that, for the manufacturing firms it surveyed, over 70 per cent of the broad motivation for their offshore investment was provided by market-based considerations. For service sector firms, it was over 80 per cent.

The BIE also found that, for the manufacturing firms, about 16 per cent of their broad motivation to locate offshore was provided by costs and input-related factors; for the service sector firms the figure was 11 per cent.[3] (As noted later, these factors are also the major drivers for mining companies, which were not covered in the BIE survey.) The BIE found that host country and Australian government policies were less important considerations (9 per cent and 4 per cent, respectively, for manufacturing firms).

The survey results need to be interpreted carefully. In particular, it needs to be recognised that the findings reported above relate only to the broad general reasons underlying offshore investment decisions. While not the dominant factor overall, government factors influence the decisions of many firms. They can often 'tip the balance' in favour of investing offshore. And they can influence the choice of location once a decision to invest offshore is made. Moreover, once companies have overcome the costs and difficulties of moving operations offshore, they can become more sensitive at the margin to policy-related differences.

Comments made by participants suggest that location decisions by mining companies are more sensitive to government-related influences. Mining production is characterised by investments which are generally capital-intensive and long-lived in character, so that government influences, and in particular the stability of the policy regime, can make a big difference to expected returns. Mining companies also face a range of possible investment location choices and their exploration expenditures tend to be 'footloose'. The Association of Mining and Exploration Companies contended that, after prospectivity, the effect of government regulation and policy is "one of the biggest contributing factors to the movement of mining investment offshore":

> ... mining companies are being ... forced to reduce domestic investment due to the many taxation, environmental and land access difficulties and disincentives existing in Australia ... this type of offshore investment detracts from domestic investment (Sub. 30, p. 4).

[3] The figures are the sum of two categories used by the BIE — 'cost-based' and 'natural resource-based' motives. The latter was zero for the service sector firms.

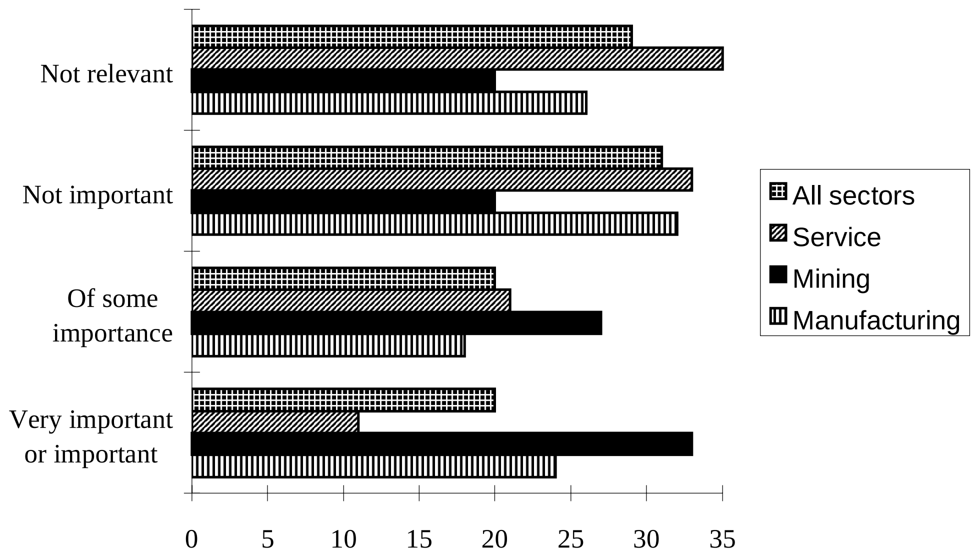
BHP said that:

> The minerals industry is now global, and government policies in this sector are critical in determining where mineral exploration and development takes place (Sub. 38, p. 3).

The significance of government influences is confirmed by the results of the Commission's own survey which, although mainly directed at assessing the impact of offshore investment on the Australian economy, included some questions on firms' motivations (see Box 3.3 and Appendix D). It found that 34 per cent of respondents considered host government factors either 'very important' or 'important' to their decision to invest offshore. The corresponding figure for factors subject to Australian government control was 20 per cent, including one-third of the mining firms which responded — see Figure 3.1.

While the data highlight the particular importance of Australian government factors to mining firms, these factors were either 'not relevant' or 'not important' for a majority of the service sector firms surveyed. Manufacturing firms fell between the two. The findings of this survey are broadly in line with those of a separate survey carried out for the Commission by the Business Council of Australia (see Appendix C).

Figure 3.1: Importance of Australian government factors relative to commercial factors
(percentage of responses)



Source: IC survey (see Appendix D).

The remainder of this section looks in more detail at particular investment motives within the four broad categories identified earlier.

Box 3.3: Main findings of some recent surveys

Industry Commission (1996) — This survey covered some 150 firms engaged in ADIA in the manufacturing, service and mining sectors. It found that commercial considerations were generally more important than government-related influences in inducing firms to undertake offshore operations. Although less important overall, both host and Australian government factors were important for some firms. Competition policy, labour market policies, taxation arrangements and Australian tariff policies were each cited by about 14 per cent of respondents as influencing their decisions to invest offshore.

BIE (1995) — In its survey of 35 manufacturing and 10 service firms, the BIE (1995f) found that 'market-based' considerations (in particular, the growth potential of the host market) were most influential in firms' decisions to invest offshore. These accounted for more than 70 per cent of the total motivation for manufacturing firms and over 80 per cent for service sector firms. Cost-based considerations accounted for 14 and 11 per cent of the total motivation for manufacturing and service sector firms, respectively. Natural resource-based, host and Australian government factors were relatively unimportant.

Edwards and Buckley (1995) — This survey of 38 Australian manufacturing firms located in the United Kingdom (20 firms), Malaysia (14) and Thailand (4) concluded that the main motive for establishing subsidiaries in each of those countries was to promote market growth. It was generally the local, not the regional markets, which were the initial attraction. Labour costs were seen as secondary factors for firms located in Malaysia and Thailand, and the low cost of business overheads was another secondary factor favouring location in Malaysia. For some firms located in the United Kingdom, labour costs had influenced the choice of region.

EAAU (1994) — In its 1993 survey of 18 firms with offshore investments in South-East Asia, the East Asia Analytical Unit of the Department of Foreign Affairs and Trade found that the main motives for investing in South-East Asia were to extend business networks and to take advantage of expected growth in the host market. Less significant factors were incentives offered by the host country and the desire to reduce transport and logistical costs, and to overcome trade barriers.

McKinsey & Co. (1993) — As part of a survey of some 300 *Emerging Exporters*, this study reported on 39 offshore manufacturers. Each was asked to nominate the three main reasons for moving offshore. The main reasons cited were: to be closer to customers (59 per cent of total responses); to take advantage of market growth (46 per cent); to achieve lower labour costs (44 per cent); to achieve lower freight costs (28 per cent); and to benefit from government assistance (23 per cent).

Note: See Appendices C and D for further information on these surveys.

Market demand-oriented influences

ADIA has arisen largely because firms in Australia have sought to use their particular advantages to exploit opportunities for growth and expansion, and there have been increasing opportunities to do so offshore. As noted above, the dominance of market-based motivations is a consistent conclusion in the literature and in surveys, and from evidence provided to this inquiry. The BIE (1995f) found that the growth potential of the host country market was the single most important market-based motivation, accounting for 61 per cent of all market-based factors for the manufacturing firms surveyed, with closer proximity to customers accounting for 17 per cent. This section discusses these influences, and also considers the influence of the limited size of the domestic market and of risk factors.

Growth opportunities in the host market

Much ADIA arises simply because firms seek to take advantage of growing demand in the host country market — often in their core activities, but sometimes in upstream or downstream activities. For example, in a MTIA survey of 30 companies, 81 per cent of companies with a manufacturing operation indicated that the primary reason for establishing an offshore operation was to locate in a growing market. Box 3.4 summarises why some Australian firms located subsidiaries in the United Kingdom.

An important factor which drove two leading Australian transport companies — TNT and Brambles — to invest in Germany was the size of Germany’s domestic market (Allen Consulting Group 1995b), while Pioneer said that:

> ... the growth of demand for pre-mixed concrete in many countries is substantially higher than Australian growth rates due to both economic growth and switching from on-site concrete production to pre-mixed. Compared to Australia’s growth rate for pre-mixed concrete of 6% over the period 1992–95, most Asian countries grew at greater than 10% (Sub. 4, p. 6).

In South East Asia, high economic growth has provided investment opportunities for service sector activities, such as insurance. For instance, QBE Insurance has established operations in many countries in the region.

Increasingly, there are larger offshore markets to tap into as countries which previously restricted inwards investment open their doors to trade and investment, and/or reach a stage in their development when they demand more of the types of products which Australian firms have experience and expertise in producing.

As noted previously, other surveys also show that the prospect of market growth is the major factor stimulating Australian direct investment abroad.[4] These survey findings are consistent with information provided to the Commission during the inquiry by a range of firms and organisations, including Brambles, Arthur Anderson, Tubemakers, James Hardie, the MTIA and the Australian Stock Exchange.

Box 3.4: Why have Australian companies invested in the United Kingdom?

The United Kingdom has been the most popular destination of ADIA. Interviews conducted by the Allen Consulting Group suggest that the major reasons for Australian firms locating in the United Kingdom have been:

- growth opportunities in that market;
- access to natural resources;
- knowledge of the market and the business culture, in some cases arising from a long business relationship (for example, the four major banks have had branches in London for many years);
- confidence that they can add value to the businesses acquired;
- similar legal and accounting systems and, in many industries, similar regulatory systems;
- opportunities for expansion into other European markets; and
- the English language.

Source: Allen Consulting Group 1994, p. 95.

But each company has its own story. For example, Burns Philp (see Box 3.5) said that, to help meet the strong demand for baked foods in India, it acquired the Indian Yeast Company, India's largest yeast producer. Because fresh yeast has a short shelf life, it must be produced close to the market: foreign demand for this product cannot be met through exporting. Furthermore, yeast is best supplied locally from medium-sized plants. This suited the company because of its technological expertise in process control and construction of this scale of plant.

[4] For example, BIE 1995f; Edwards and Buckley 1995; AEEMA, Sub. 16; EAAU 1994; Allen Consulting Group 1994; and Bennett, Merchan and Metcalfe 1981.

Box 3.5: Burns Philp's decision to invest offshore

Burns Philp is an Australian pioneer in offshore investment. It is now a global food ingredients company with operations in over 30 countries and customers in 60 countries. It is the world's largest manufacturer and marketer of bakers' fresh yeast, the second largest processor and marketer of spices, and a leader in a range of other natural food ingredients.

For Burns Philp, the motivation to go offshore has been commercial. There are no important Australian 'push' factors. It had to go offshore because it already had 95 per cent of the yeast market and about 60 per cent of the other food markets in which it competes. Thus, the potential for further growth in Australia was very limited.

While fresh yeast must be produced locally, dry yeast can be exported. As a result, the company is engaged in a mix of offshore investment and exports. It seeks to produce dry yeast at the lowest cost locations and to export from there.

The company's success is attributed mainly to its proprietary technology developed through a strong commitment to research and development and application of the technology to help its customers make better food products.

The company received tax concessions when it first established in Indonesia and Malaysia; they were not a reason for investing, but they improved the return on an otherwise risky investment. It is currently constructing plants in Brazil (100 per cent owned) and in Vietnam (a joint venture).

Sources: Burns Philp 1995; Sub. 10; company visit.

In some cases, the opportunity for growth may be attributable to overseas investment by another Australian company. For instance, the presence of an Australian firm in an overseas location can induce a shift offshore by firms which supply inputs to its Australian operation. This occurred when Goodman Fielder commenced production of margarine in Malaysia and, subsequently, Indonesia and the Philippines. The firm which produces its plastic containers in Australia moved with them, establishing production in both Malaysia and Indonesia.

Similarly, important investment opportunities can arise from the location of a related firm. For example, BHP has located its offshore cold rolling, coating and painting plants close to its previously established roll former plants:

> ... the roll former[5] needs to be assured of an uninterrupted supply of steel feed without having to hold large stocks. This factor, together and more importantly

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5 Roll forming is a finishing process in flat steel production in which coated and painted steel sheet is rolled into a range of different profiles.

> with the rapidly growing demand from third parties in many developing countries, influences us to locate cold rolling, coating and painting plants overseas adjacent to our roll formers (Sub. 15, p. 7).

In some instances, the act of locating offshore may itself create growth opportunities for the investing firm (or for other Australian firms). For example, a respondent to a survey undertaken by the Australian Electrical and Electronic Manufacturers' Association (AEEMA) said that one reason for locating operations in Indonesia was because of the subsequent opportunities it presented for sales to the Middle East (because of common religious customs and observances). In a similar vein, the ACM said that locating overseas can provide Australian firms with preferential access to related markets under regional trade agreements. For instance, under the North American Free Trade Agreement, an Australian firm producing in Mexico obtains duty free access to the United States and Canada. Similarly, Pacific BBA said that, once it had established in some countries in Asia, it could take advantage of:

> ... preferential arrangements for ASEAN countries which add further to the benefits of manufacturing within the region (Sub. 1, p. 1).

Limited domestic market

For some firms, seeking growth opportunities offshore is a more direct consequence of the small size of the Australian market and the limited prospects it provides for growth. To expand faster, these firms need to export or produce overseas. In this context, Yetton, Davis and Swan (1992) said that:

> ... without the benefits of a large domestic market or an easily accessed large neighbourhood market, we should not be surprised that many of [Australia's] most successful manufacturing firms have favoured multi-domestic[6] strategies (p. 79).

A number of companies participating in this inquiry said that they had moved offshore because they considered that further growth in Australia was limited. A clear case is BHP, which said it had outgrown the Australian market in many of its activities. It added that:

> ... the largest unsatisfied and/or fastest growing markets are in many cases outside Australia. Therefore to achieve growth in sales of many of our products, BHP must sell outside Australia ... *Selling* internationally often *of necessity* involves *producing* internationally as well, and it is this necessity which determines many of our decisions to invest overseas (Sub. 15, p. 3).

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6 A 'multi-domestic' is defined as a firm that locates its production for foreign markets in those countries, instead of exporting from the home base or from a regional base. In effect, the goods and services are produced in the locations in which they are sold.

The building supplies industry, for which exporting is usually not an efficient way to meet overseas demand, provides another example. The expansion of James Hardie's fibre cement plant in Florida and the construction of a new 230 million square feet facility in Texas will give the company the capacity to make more than 700 million square feet of fibre cement in the United States in 1998. This is about three times its United States production capacity during the past year. It is also two and a half times the total Australian market for fibre cement (James Hardie 1996, pp. 8-9). Similarly, James Hardie's production of plasterboard in the United States will exceed the output of the entire plasterboard industry in Australia.

The role of limited or constrained domestic markets was noted also by a number of other participants (including Boral, CSR, Burns Philp, Goodman Fielder and the ANZ Bank).

The benefits of greater proximity to customers

For many products, whether tradeable or not, there are clear advantages in serving an offshore market with some form of local presence. It allows firms to develop a local identity or 'image', to provide after-sales service more effectively, to respond to shifts in demand quickly and to customise the product or service to better meet local requirements. It may also facilitate firms' provision of goods on a 'just-in-time' basis and, in most cases, will provide firms with better, or more timely, information on overseas markets.

Several participants confirmed these benefits. Brambles said that an initial local presence in Europe allowed it to develop a network of contacts which then facilitated the development of further businesses. For example, BHP said that locating its roll-forming plants close to its customers allows the company to respond quickly and flexibly to demands for a wide range of steel products. Similarly, Pacific BBA said that its:

> ... steel gratings for elevated floors are ... generally customised to suit the application. Being close to the market is extremely important (Sub. 1, p. 2).

In ACM's view, proximity to customers "remains the over-riding factor" in decisions to locate offshore. Similarly, the MTIA's survey of 30 member companies revealed that proximity to customers was a key factor in the decision to establish offshore operations for 75 per cent of those companies which had an overseas manufacturing operation. Many companies provide a 'just-in-time' service to their customers. The Commission was also told that Bundy Asia Pacific (which makes components for Daewoo cars) needs to be in Korea because Daewoo wants its suppliers "next door".

Potential customers often include foreign governments. In this context, AEEMA said that, for firms in the electrical and electronic industries, a local presence is a prerequisite for applying for contracts from government agencies.

Box 3.6: Austrade's view on why firms locate offshore

In Austrade's experience, the nature of the involvement in outwards investment varies between industry sectors, the types of activities which companies are involved in and the key markets for the products or services concerned. However, four primary motives appear to be most influential.

1. To secure low factor costs, with export to the home country or third countries in mind — for example, BHP's copper mine in Chile and Pacific Dunlop's gourmet factory in China.
2. To profit by the application of a superior business system for non-tradeable goods and services — for example, National Australia Bank's activities in provincial United Kingdom and Pioneer Concrete's involvement in Hong Kong and Israel.
3. To establish a beachhead for imports from the home country — for example, BHP's roll-forming in the United States and Asia of coated steel sourced from Australia.
4. To gain access to technology.

Other significant issues in the decision to invest offshore range from cost competitiveness, to the need to meet specific delivery requirements in order to be considered as a supplier (for example, to meet the needs of companies operating on the basis of 'just-in-time' supply), to the need to get behind existing tariff or non-tariff barriers in a particular market. For example, Australian educational institutions seeking to export educational services overseas will increasingly be faced with the necessity to establish colleges in the local markets to conduct part or all of their courses there. Similarly, Australian companies wishing to sell medical services will increasingly be investing overseas in private medical facilities, such as clinics, hospitals, etc.

Source: Adapted from Sub. 25, pp. 5-6.

Diversifying market risk

Some firms told the Commission that they use offshore investment, in part, to spread commercial risks over a number of different markets. This can be particularly important for firms which specialise in a relatively narrow range of products. Locating in a number of different countries effectively provides some cushioning because the product demand cycles within each country are unlikely to move in unison. For example, the building supplies industry may be experiencing an upswing in the United States when it is contracting in Australia.

ADIA provides firms within that industry some scope to reduce the concentration of their risk exposure.

The cost and availability of inputs

A number of studies highlight the importance of access to raw materials and natural resources, and to other inputs such as cheap labour, to the investment decisions of some multinational firms (for example, see Moxon 1974 in Buckley and Casson 1985). Some are able to substitute between investment and trade depending on, for example, the cost of production in the destination market relative to the combination of production costs in the source country and transport costs.

In some situations, the relative cost, availability and efficiency of economic infrastructure in the home and host countries can exert some influence on location. Infrastructure in Australia can act as a ‘push’ factor if it is less efficient than in other countries — transport infrastructure (for example, ports) is often cited as imposing costs on exporters, and may increase the incentive for a firm to move offshore (see Chapter 9). Equally, relatively low cost and/or high quality infrastructure in a host country can act as a ‘pull’ factor.

There is corroborating evidence from participants and from surveys that differences in costs of production influence Australian firms to invest abroad. According to the Council of Textile and Fashion Industries, a large number of Australian firms in the textiles, clothing and footwear (TCF) industry have undertaken considerable ADIA primarily for cost reasons. For manufacturing firms more generally, the BIE found that, of the cost-based motivation, about 62 per cent was provided by lower input costs (including labour costs) and more reliable supplies. This section looks at the influence of the cost and availability of labour, raw materials and natural resources.

Labour costs

For most firms, the cost of labour has not been the dominant influence on a decision to move offshore. For example, both the BIE (1995f) and Edwards and Buckley (1995) found that labour costs were an important but secondary motivation for offshore investment by Australian manufacturing firms (see Appendix C). This result is consistent with that of McKinsey & Co. (1993, p. 32).

Nevertheless, for individual firms which produce labour-intensive products, there can be significant advantages in operating in locations where labour costs are relatively low. According to Howe (1994):

> There is little doubt that moves offshore in these industries [for example, TCF] reflect cost disadvantages of locating certain stages of manufacturing in Australia (p. 127).

However, in assessing the extent of the labour cost advantage, account must also be taken of relatively lower levels of productivity existing in some low-wage countries. A specific example illustrating this trade-off for an Australian shirt manufacturer is outlined in Box 3.7.

Firms in the labour-intensive TCF industries have benefited by operating in countries with much lower labour costs. The Textiles, Clothing and Footwear Development Authority said that much of the investment offshore in clothing and footwear has been directed to China (where labour costs are estimated to be 4 per cent of those in Australia). Most of this has been in low value-added clothing manufacture (TCFDA 1993).

Pacific Dunlop also drew attention to China's low labour costs, noting that employment in its Australian TCF operations has declined significantly, while employment in its operations in China and, more recently, Vietnam, has increased. Pacific Dunlop said that, if it had not invested in offshore TCF production, it would have been forced instead to import TCF products from foreign suppliers and would still have run down its local TCF operations. The Council of Textile and Fashion Industries also argued that lower wage and other operating costs led the Australian TCF industry to switch much of its production offshore.

Garmond Australia, a producer of picture frames, noted the differences in wage costs faced by Australian manufacturers and those in countries such as China, Indonesia and the Philippines, and said:

> ... it is easy to see huge profits in just the labour cost differential (Sub. 3, p. 2).

James Hardie said that, for some of its high labour content manufacturing (for example, building access control systems), it has investigated establishing operations in Mexico to take advantage of, in particular, lower labour costs.

Other participants, such as the MTIA, pointed to the importance of labour on-costs as a factor underpinning offshore location decisions. The ACM said that:

> ... for some footwear and clothing manufacturers, where labour inputs represent a significant component of costs, the decision to locate offshore in countries like Thailand and Indonesia, is driven by the need to lower labour costs (particularly on-costs) (Sub. 7, p. 3).

Box 3.7: Lower labour costs led shirt manufacturer offshore

Sydney shirt manufacturer Mark Halabe said that he was reluctant to move the major parts of his business to Fiji because he knew that it would mean a drastic cut in his Australian-based workforce. But the relocation advantage was too compelling to ignore.

At that time (1992), a machinist at his Marrickville factory earned $A540 a week, while in Suva a machinist earned $40 a week. This led Mr Halabe to move most of his company to Fiji, even though his Australian workers had achieved high levels of productivity — the 80 remaining workers of Mr Halabe's original Australian workforce of 140 made 7000 shirts each week, while the 177 workers employed at Mark One Apparel in Suva made only 5000. He said — "My Sydney workers are the best in the world, but they earn more than ten times the wages of Fiji workers. We had to go offshore to survive".

Mr Halabe's decision to leave Australia was based not only on lower wages, but also on the Fiji Government's offer of a 13-year company tax holiday.

In his submission to this inquiry, Mr Halabe said that the productivity of the Sydney workers remains more than twice that of those in his Fiji factory. Nevertheless, he argued that other factors including wage rates, workers' compensation, restrictive work practices, superannuation, payroll tax, holiday loading, dealing with unions, long service pay, redundancy liabilities and other regulatory restrictions have been good reasons to leave Australia for less developed countries. He gave as one example holiday pay — which for his 100 Australian employees amounts to some $250 000, while his 158 Fijian employees are entitled to $22 000.

Sources: Sub. 17 and *Time*, 9 March 1992, pp. 18-20.

While differences in wage rates were of little importance in Ceramco Corporation's decision to move all production of its Bendon and Hickory lines of women's clothing from Australia to New Zealand, labour on-costs were a crucial factor. These were estimated by the firm to be about 42 per cent of total labour costs in Australia, compared with 14 per cent in New Zealand. Bendon and Hickory products are now produced in New Zealand and imported into Australia.

More detailed discussion of these matters is contained in Chapter 6.

Raw materials and natural resources

Access to raw materials is crucial for some firms. If essential raw materials or other natural resources are not available in the home country (or if the costs of gaining access to them are high), firms will naturally seek them offshore (see Box 3.8). Mining companies, for example, locate wherever they find suitable quality mineral deposits which can be extracted economically (having regard to various types of risk). BHP said that:

> Australia happens to be well endowed with good mineral deposits but so also are many other countries, and selling on the world market necessitates looking worldwide for the best deposits to develop (Sub. 15, p. 4).

Box 3.8: 'Prospectivity' and low costs encourage BHP offshore

BHP's minerals group operates in global markets. The company said that, to be successful, it needs to produce as competitively as possible — this means operating world-class mines with high grade ore and/or low extraction costs. It added that all the major Australian mineral companies are now either operating or exploring overseas, as well as in Australia.

In the case of copper, BHP is concerned to remain one of the world's largest low-cost producers. It has significant interests in South America (for example, in the Escondida mine in Chile, said to be one of the lowest-cost copper mines in the world). Its recent purchase of the Magma Copper Company has also given it a stake in Chile's Tintaya copper mine.

The large-scale South American mines are creating low (and highly competitive) operating costs through massive annual production rates. BHP said that improved extraction, smelting and refining processes, including *in situ* leaching of ores, may cut costs further. It added that there is considerable room for expansion in its South American copper activities.

Source: Sub. 15.

The Minerals Council of Australia said:

> The prime reason ... for becoming involved in overseas operations is that companies will go to where the best mineral deposits can be found and developed (economically) profitably (Sub. 24, p. i).

Gwalia Consolidated said:

> The fundamental reason for extending our activities overseas is the geological prospectivity of regions outside Australia for the minerals which we seek — principally gold (Sub. 11, p. 1).

For similar reasons, other Australian mining companies such as MIM and CRA have sought overseas supplies of minerals. CRA has developed copper mines in Papua New Guinea, and coal and gold mines in Indonesia. It is exploring for copper and gold in Laos, and is evaluating a potash deposit in Argentina. MIM is expanding into South America on a large scale.

Access to raw materials or other natural resources is also an important consideration for some manufacturing firms. For example, Ansell located in Malaysia to be close to the supply of the raw latex which is used to produce rubber and related products. However, for most manufacturing firms, access to raw materials is a relatively unimportant influence on location decisions (BIE 1995f). An MTIA survey reported that only 3 per cent of respondents saw proximity to raw materials as a critical factor in offshore location decisions.

Host government influences

Surveys indicate that, in aggregate, host government influences are less important than market demand-based and cost-based factors. They accounted for only 9 per cent of the broad motivations for manufacturing firms in the BIE study. Nevertheless, the attitude and policies of the host country government can influence individual investment decisions. Trade barriers, government incentives, foreign investment rules and the cultural, economic and political environment of the host country all appear to be relevant factors. They can tip the scales in a decision about whether to move offshore and can influence the form of investment (wholly-owned subsidiary or joint venture), as well as the choice of country (or region within a country) in which to locate.

This section looks at the incentives for offshore investment provided by trade barriers and host government incentives. It also briefly considers the effects of some broader cultural, political and economic factors.

Getting behind trade barriers

If a country imposes barriers to imports, some producers may find it more profitable to establish production facilities ‘behind the tariff walls’ in that country, thereby substituting foreign production for exports. (Indeed, Australia’s history of relatively high levels of protection was responsible for the establishment of many foreign subsidiaries in Australia.) The alternative may be lower sales to the country concerned, or no sales at all.

A number of studies have found substantial evidence of direct investment in offshore facilities occurring to avoid trade barriers.[7] For example, Rugman (1986) commented:

> ... the switchover from exporting to international production will inevitably be influenced by ... changes in tariff and non-tariff barriers to trade (p. 105).

Information provided to the Commission supports this conclusion. For example, an important reason for BHP establishing a mini-mill in the United States was to by-pass trade barriers. According to BHP, the "voluntary export restraints" on exports of steel to the United States also had an important influence on BHP's decision to locate a new cold rolling, coating and painting line in that country to supply feed to its roll formers. It added that:

> In Asia, tariffs on steel are higher the further down the production chain one goes, and this supports our policy of undertaking at least the more downstream activities inside those domestic economies (Sub. 15, p. 8).

Similarly, at the ACCI Round-table, Goodman Fielder indicated that it was necessary to locate production in foreign markets where tariffs on processed foods were high. If tariff rates were lower, the company would prefer to export from Australia where, generally speaking, production is more efficient.

The Council of Textile and Fashion Industries said that quotas, country of origin provisions and other restrictions on access to the markets of some countries had encouraged a shift offshore of TCF production which, in the absence of those trade distortions, would have been internationally competitive in Australia.

In a survey of six member firms, AEEMA found that high tariff barriers in APEC economies were an important factor driving firms to invest in that region. According to AEEMA, non-tariff protection, such as onerous product testing requirements, frequently increases exporting costs and adds to the attraction of manufacturing in foreign countries.

Pioneer, which both produces in, and exports to, several Asian countries, also noted the high tariffs applying in Asia. While it would like to establish a substantial export business for plasterboard into Thailand (and into other Asian nations), it would face an import duty of 40 per cent. The company does not consider that it could compete on that basis:

> If Pioneer wants to supply the Thai plasterboard market, it must invest in facilities in Thailand (Sub. 4, p. 4).

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[7] For example, Brainard 1993b. See also Dunning 1986 and Hill and Lindsey 1987, cited in UN 1992.

Robert Bosch (Australia) said that tariff and non-tariff barriers on automotive components made it difficult to export to some Asian nations. As a result, it is currently pursuing joint venture arrangements to produce components in four countries in the region.

By investing within the host country, firms not only avoid tariffs or quantitative limitations on their exports to that country, but can also derive enhanced access to other countries where there are regional trade agreements that include the host country. Pacific BBA said:

> ... because of tariff and non-tariff barriers existing between the Asian countries and Australia, export from Australia of certain products is commercially prohibitive. Once behind these barriers there are preferential arrangements for ASEAN countries which add further to the benefits of manufacturing within the region (Sub. 1, p. 1).

Incentives provided by the host country

Many countries, particularly in the Asia-Pacific region, offer incentives to attract foreign investment. Most of the incentives are tax-related. They include corporate taxation at rates considerably lower than in Australia, concessions which reduce tax liability (such as accelerated depreciation) and tax holidays. In addition, a range of other incentives are available, including import duty exemptions and subsidised land and infrastructure. For example, Malaysia offers approved projects five-year tax holidays and exemptions from import duties for machinery and raw materials.

The capacity of Australian multinational firms to benefit from overseas tax concessions depends, in part, on the Australian tax treatment of foreign-earned income. For instance, income earned in many developing countries is taxed in Australia such that the total tax paid (foreign tax plus Australian tax) is the same as that which would have been paid if the income were earned in Australia. However, in some instances, ‘tax sparing’ arrangements preserve the tax benefits gained by Australian firms. These matters are discussed in some detail in Chapter 5.

The MTIA reported that 38 per cent of firms it surveyed which have located offshore considered inducements offered by host governments to have been a factor in the decision. Nevertheless, it appears that most firms do not value host country incentives highly enough for them to be the deciding factor in decisions to invest offshore. For example, while some AEEMA member companies which have located in Malaysia cited that country’s Pioneer Status program (which offers a range of incentives for the first five years) as an important reason for locating operations there, AEEMA’s general conclusion was that, while these incentives *enhance* the financial position of investment proposals, they do not, in isolation, induce companies to establish operations offshore. AEEMA said that they:

> ... could influence the location of the operations either between competing countries or between regions of a country (Sub. 16, p. 5).

Many companies which discussed such incentives with the Commission regarded them as little more than 'icing on the cake'. Based on its discussions with firms which have located offshore, the Australian Stock Exchange also judged that inducements offered by a host country were "an added bonus", but not a determining factor (Sub. 6, p. 1).

Some international surveys reach similar conclusions. For example, a survey of United Kingdom overseas investors found government incentives in the host countries to have had a negligible influence on investment decisions (Shepherd, Silberston and Strange 1985).

These views are consistent with other evidence presented to the Commission. Pioneer, for instance, said that it has benefited from accelerated depreciation arrangements in Malaysia and tax concessions in Israel, but that:

> ... such incentives are not a significant factor in Pioneer's decision to enter or invest in a country. Pioneer takes the view that its business must be viable without such incentives, which are often not permanent (Sub. 4, p. 6).

Other participants (for example, James Hardie, Goodman Fielder and Robert Bosch) made similar observations. In many cases, overseas government incentives are seen as providing little more than an offset for infrastructure deficiencies in the host country.

Culture, politics and economic management

Similar language, legal structures and cultural conditions can attract investors to a country even if it is far afield. This has been true for many Australian firms undertaking direct investment abroad, and is reflected in the concentration of ADIA in the United Kingdom and the United States.

Asia is sometimes seen as a riskier or more difficult environment. Many firms interviewed as part of the Yetton, Davis and Swan (1992) study adopted the rule of thumb of "one risk at a time" for a new investment project:

> ... firms believe that they can cope with one source of competitive, if temporary, disadvantage at a time ... the most part of Asia is seen as entailing more than one dimension of significant "risk", while the UK and America may present just only one (p. iv).

According to that study, many investors focus initially on markets that are culturally familiar, with other markets being considered only as companies gain experience offshore. A number of other studies support this view. For example, a United Nations review of service industries (UN 1993b) also found that, in the early years of international expansion, firms tend to invest in countries with a similar culture. Only later are investments extended to culturally less similar countries.

While many firms prefer to invest first in regions where the legal framework is similar to that in Australia, and where business is transacted in English, there are examples of firms moving directly into countries with quite different cultures and traditions. Some have succeeded immediately; others have found the problems to be greater than they expected. For example, Tubemakers' first offshore investment was in South Korea, generally considered one of the more difficult markets. While encountering some initial problems, the company is now expanding its activities there.

The host country's political environment can also be important to decisions on where to invest. In some countries, changes in government lead to major changes in the rules of business and commerce. This can influence location decisions through the uncertainty caused (Hosseini 1994). In other cases, the legal and economic framework itself may not be sufficiently well developed, and firms operating there will have to adapt (presumably at a cost) as circumstances change. A number of participants cited Vietnam as a case in point.

For firms with long-lived investments — such as mining companies — the policies (and political stability) of the host country are crucial. (Box 3.1 discusses CRA's experience in Indonesia.) Evidence from surveys confirms the importance of political factors. In the EAAU (1994) survey, 14 out of 18 firms which invested in South-East Asia had taken these factors into account in their planning. Many mining companies noted that Latin America is widely seen as more favourable now because of improved political stability and better economic management. BHP said that:

> In terms of planned capital expenditure, South America now dominates the world scene, accounting for 35% of total planned expenditure for 1995. These developments can partly be traced to economic reform and greater stability in many South American economies (Sub. 38, p. 3).

A decision about investment location also depends on the size and economic strength of particular economies, including their economic growth, per capita income and macroeconomic management. One study which examined this relationship found that the magnitude of foreign investment in a country is strongly correlated with indicators of market size (population and per capita GDP) and openness (Hufbauer, Lakdawalla and Malani 1994).

Home government influences

The policies of Australian governments also influence decisions about where to locate production, both within Australia and overseas. The regulatory environment (such as environmental and land use legislation), competition policy, labour market and trade polices have all been identified. For example, some mining companies argue that restrictions on land use within Australia are 'pushing' investment offshore. These issues are considered further in later chapters.

The BIE (1995f) found that Australian government influences were second order reasons for manufacturing firms investing offshore. However, they can be significant for particular firms or industries.

The impact of labour costs on the decisions of firms to invest offshore has already been mentioned. Australia's industrial relations framework is evolving from a system based on centralised wage bargaining to one that relies more on negotiation within enterprises. While recent changes provide more scope for employees and employers to negotiate at the workplace level, many participants considered that the current arrangements continue to constrain productivity growth. This is considered further in Chapter 6.

The rest of this section looks briefly at the effects of Australia's tariff regime, competition policy, environmental regulation and native title legislation.

Australian tariff policy

Broadly, tariffs have two effects. The first and perhaps more significant effect relates to the protection tariffs afford to the *outputs* of domestic industries. The continued lowering of tariffs is exposing increasing numbers of Australian firms to greater foreign competition. While Australia as a whole is benefiting from this, some firms are becoming less competitive in the domestic market. This has created incentives for them to locate some or all of their production activity offshore. The MTIA said that:

> ... the reduction in tariff barriers in Australia has resulted in significantly increased pressure on Australian industry to become internationally competitive. Some companies facing intense international competition have made the decision to re-locate production to an offshore market, rather than lose this area of manufacturing capability altogether (Sub. 9, p. 18).

As noted previously, significant offshore investment has occurred within the clothing and footwear industries. The ACM said that:

> With the average rate of duty on imports to Australia being cut by one-third on these products [clothing and footwear] over the last decade, a number of

> Australian firms have moved production offshore, while maintaining their headquarters and design houses within Australia (Sub. 7, p. 3).

At the ACCI Round-table in Brisbane, Burleigh Textiles said that, because textiles manufacturers cannot compete, many are moving their plants offshore. Supporting evidence is contained in a survey conducted by the State Bank of New South Wales and the Chamber of Manufactures of New South Wales (1993) which found that, within the manufacturing sector, clothing and footwear have been the activities with the greatest propensity to move offshore.

A second effect relates to tariffs on inputs which can raise production costs. For example, Garmond Australia saw duties on imported raw materials and equipment as an impost on production, making exports more expensive. Consequently, firms using imported inputs which attract duties may be able to reduce their costs by producing offshore. However, this is now unlikely to be a strong factor influencing location decisions of most manufacturing firms — tariffs on inputs are, on average, lower than on outputs, and tariffs are now at relatively low levels. For firms in the services, agriculture and mining sectors, tariff issues remain of some importance — especially now that the margin of concessional entry has been reduced — but there is little evidence of this being a significant influence on offshore location.

Competition policy

The Australian Competition and Consumer Commission (ACCC) is the key regulator of competition polices in Australia. One of its roles is to prevent mergers that could substantially lessen competition in a market (unless there are offsetting public benefits).

A number of major Australian firms told the Commission that merger regulation prevented them from expanding their domestic market shares by merging with, or taking over, local rivals. Consequently, any expansion required a move offshore. For example, the current approach to banking mergers is seen by some of the majors as effectively precluding them from purchasing any large regional bank in Australia. Similarly, firms in the building supplies industry told the Commission that their ability to expand in Australia was seriously restricted by the present approach to mergers.

While it is important that mergers and acquisitions do not result in a concentration of market power, it is also important that regulatory arrangements are not administered too restrictively. Mergers and acquisitions can allow firms to reap economies of scale and better combine resources, and can be an important means of achieving a more efficient and productive economy.

These matters are discussed further in Chapter 9, in the context of the broader benefits which merger regulation provides, and the processes by which it is administered.

Other regulation

Governments play an important role in regulating a wide range of activities. As regulation invariably has attendant costs, its form and implementation can have important implications for community welfare. To be effective, regulation needs to be well designed and managed, but this is not always the case. There is not always adequate assessment of the need for new regulation, or of the form it might best take. Problems also can arise if regulation does not have the flexibility to adapt to changing market conditions.

While many government regulations have an impact on business, land use and environmental regulations have been cited as being significant enough to influence offshore investment decisions. This is particularly true for the mining industry, where some companies claim that the level of uncertainty they experience when operating in Australia is now greater than in a number of highly ‘prospective’ developing countries.

Environmental regulation

A relevant question for this inquiry is whether environmental regulations (for example, pollution standards or restrictions on land use) affect the location decisions of firms. Some assume that trade and investment liberalisation will encourage a shift in location of highly polluting industries to countries where environmental regulations are less stringent; other evidence challenges this view.

Of importance for business location decisions is not just the stringency of environmental regulation, but the form it takes. For instance, some governments mandate specific control technologies or processes. Countries which avoid such prescriptive approaches may be more attractive to investment, as this allows firms to choose the least-cost way to meet environmental standards.

Several participants expressed concern that access to land has become restricted under conservation regimes which do not provide for multiple land use. The Minerals Council of Australia estimated that 13 per cent of Australia is no longer available for exploration as a result of conservation arrangements. CRA said that there has been continual pressure on governments to create more ‘no go’ areas for mineral exploration. It argued that mining companies will direct more exploration expenditure offshore if they can not get access to prospective land in Australia. Other mining firms argued similarly.

Recently there have been attempts to have an environmental code of conduct set in place for Australian firms operating in other countries. In essence, this would seek to have Australian firms put in place environmental practices similar to those they employ in Australia, irrespective of the standards established by the host government. These matters are discussed in Chapter 7.

Native title legislation

The Commonwealth Government introduced the Native Title Act in 1993 in response to the High Court's decision in *Mabo and Others v The State of Queensland (No. 2)*. The High Court recognised native title as an interest with respect to land that survived the declaration of sovereignty over Australia by the British Crown. The existence and content of native title have their foundation in the traditional laws and customs of the Aboriginal and Torres Strait Islander people in question (see Box 8.1).

Mining organisations raised concerns about the Act with the Commission. These concerns focus on the complexity of the legislation, continuing uncertainty about the effect of pastoral leases on native title, the right to negotiate and the 'future acts' processes, and the criteria applied by the National Native Title Tribunal in assessing native title claims. Mining companies have suggested that the Act has significantly lengthened approval processes and created considerable uncertainty, making it more difficult and costly to gain access to land in Australia. As a result, some companies are said to be increasing expenditure in other countries. Such claims were disputed by Aboriginal community participants in the inquiry. These matters are discussed in Chapter 8.

3.5 Conclusions

The increasing involvement by Australian firms in offshore investment has come about largely as a result of firms using their particular competitive advantages to seek new markets, better sources of raw materials or lower cost areas in which to produce.

The evidence available from the Commission's investigations and discussions with many companies shows that market demand-based motives provide by far the most important general explanation of why firms invest offshore. The exception is the mining sector, where access to mineral deposits is the key determinant.

These conclusions are consistent with the findings of other studies undertaken both within Australia and overseas.

While government-related factors are seldom the dominant influences, they are clearly important for some investment decisions. For example, trade barriers can induce Australian firms to establish production facilities offshore, and financial incentives may influence the choice of location. In Australia, government policies which regulate the availability of land, the cost and flexibility of labour use and the nature of a firm's impact on the environment can also affect investment location decisions, especially for some mining investments.

The predominance of commercial reasons for firms locating offshore suggests that such investments are more likely to enhance the wealth of Australians than not. However, where decisions are distorted by government policy measures which artificially alter the commercial returns from operating in different locations, the economic effects of ADIA become less clear. The next chapter looks at the effects of ADIA on the Australian economy (trade, investment, employment, etc); subsequent chapters look in more detail at government policy influences on ADIA and what should be done about them.

4 ECONOMIC EFFECTS OF FIRMS LOCATING OFFSHORE

The Commission has been asked to report on the economic implications for Australia of firms' decisions to locate offshore. It has been asked to pay attention to the implications not only for national income, but also for employment levels and composition, net export performance, taxation and the treatment of repatriated profits, and changes in the size and composition of Australia's industry base.

The Commission's inquiry has been motivated by debate about the economic effects of ADIA. Offshore investment has increased considerably over the past decade, providing obvious benefits to Australian firms and their shareholders by expanding their options for profitable investment. However, some contend that ADIA occurs at the expense of exporting goods or services from a domestic production base, and amounts to 'exporting jobs' to the detriment of Australian employment levels. Similarly, there are concerns that Australia could be forgoing company income tax that it would otherwise earn if the profits were generated at home.

In considering these issues, it is important to remember that Australia remains a net capital *importer*. Its flows of direct investment offshore are still relatively small, averaging only 1.2 per cent of GDP or 10.5 per cent of total domestic investment over the last ten years. Thus, the economic effects of ADIA analysed in this chapter are also likely to be relatively small.

4.1 Issues and obstacles in assessing the effects of ADIA

Any assessment of the economic effects of ADIA needs to recognise the variety in the factors that motivate firms to locate offshore. For example, the previous chapter found that input costs were a factor driving some firms' decisions to locate offshore, but broadly speaking they were not a predominant factor. Market demand factors were found to be the major forces driving ADIA. Host government and Australian government factors were also identified as having a role. It was also recognised that Australian firms face important sources of competitive disadvantage in going offshore, and so need some major sources of offsetting advantage to make it worthwhile. In principle, the economic effects of ADIA could depend on the nature of these advantages, and on the type or mixture of motivating factors. Thus, an assessment of the overall impact needs to recognise the range of effects arising from these factors, and their relative importance.

Data constraints

Empirical evidence can shed light on the economic effects of ADIA. However, empirical assessments alone are not sufficient, partly because of limited data and partly because of difficulties in interpretation.

Official statistical data on the behavioural characteristics of foreign investment are limited (see Chapter 2). Information at the firm level is restricted to survey information, the depth and coverage of which is also limited. No information at all is collected on the production activities or trade performance of Australian subsidiaries abroad.

The lack of detailed data prevents a good understanding of some aspects of Australia’s offshore investment. For example, despite concerns raised in the inquiry about offshore investment by Australian textile, clothing and footwear manufacturers, it is impossible in the most recent published data to distinguish their foreign investment from that of other manufacturing firms. The detailed information on the operations of offshore affiliates available in some other countries, particularly the United States and Japan, has facilitated more detailed analysis of the characteristics of offshore investment. Where data constraints have prevented similar analysis for Australia, the Commission has endeavoured to ascertain whether the more general patterns of Australian investment offshore are similar to those in other countries, and therefore whether the conclusions of foreign studies are likely to be applicable to Australia.

The survey data collected recently by the Commission and other agencies, while limited in scope and subject to the usual problems of survey design, provide the opportunity to supplement published statistics and to overcome some of their weaknesses. However, the results still need to be treated with caution. In particular, it is difficult in any survey to ensure that respondents answer questions about the effects of ADIA with a consistent alternative situation or ‘counterfactual’ in mind. On the other hand, so long as firms have answered keeping in mind alternatives that are realistic options for them individually, the answers should deliver legitimate insights into the effects of ADIA at the level of the firm.

Importance of the ‘counterfactual’

An assessment of the implications of ADIA needs to answer the question ‘relative to what’? The implications could vary greatly, depending on what the alternatives to ADIA are seen as being. At the level of an individual firm, the options are:

- investing instead in a home production base from which to export;
- entering a licensing agreement with (or selling the foreign ownership rights to) a foreign producer;
- ceasing production altogether because the firm's viability is threatened by its failure to invest offshore; or
- forgoing that market.

In all but the first case, the firm is no longer making an investment in a productive facility. At the economy-wide level, the relative effects of ADIA may then depend on the alternative uses (if any) to which the shareholders put the investment funds — investment in some other activity in Australia, or some alternative (direct or portfolio) investment overseas.

In the past, there has been some relatively unproductive debate about the economic effects of firms locating offshore, with differences in conclusions arising primarily because of arbitrarily chosen differences in the perceived alternatives to foreign investment. More recent analysis of the effects of foreign direct investment has identified realistic alternatives and when they might apply, consistent with the characteristics that generated the foreign investment option in the first place. Wherever possible, the discussion in this chapter takes such considerations into account.

Firm-level information versus economy-wide effects

There are limitations in trying to use firm-level survey information to impute outcomes for the economy as a whole. From an economy-wide perspective, domestically-funded (and hence domestically-controlled) investment opportunities not taken by one firm or industry may not create a vacuum, as the funds may be used by Australian shareholders elsewhere. Survey respondents would not take into account the impact of alternative uses of Australian investment funds in a counterfactual situation, although this may be necessary for determining the economy-wide effects of an Australian offshore investment.

Since the draft report, the Commission has undertaken econometric analysis at the economy-wide level to help it determine whether the firm-level survey findings also apply to the economy as a whole (see Appendix F). The analysis is hampered by the lack of detailed information on the offshore operations of Australian affiliates and at a detailed sectoral level. However, it does provide some indication of whether total ADIA flows have any discernible impact on national outcomes for exports, imports, investment, employment and output, in each case controlling for other possible influences on these variables. As such, it gives a broad indication of the net effect of all types of offshore direct investment across all sectors of the economy.

The Commission's approach

The Commission's strategy has been to examine 'in principle' arguments from the theoretical literature and elsewhere to build up a picture of the possible economy-wide effects of offshore investment by type of motivating factor, endeavouring to make sure that both the assumptions on which the arguments are based, and their implications, are consistent with available data and qualitative information. An overall picture then emerges by comparing the relative importance of the different motivating factors. Finally, a review of the available macro-empirical studies and the Commission's own econometric work gives an empirical check on the overall effects, once all motivating factors are taken into account.

As noted earlier, some preconditions are critical to ensuring that locating offshore is a sensible investment option, given the competitive disadvantage that firms face in offshore markets. There is also a range of factors motivating offshore investment, some of which are within the control of governments and some of which are not. This chapter begins by examining the effects of investment motivated by the factors not under government control, taking account of the preconditions that are likely to make it a sensible option from the individual firm's point of view. The aim is to build up a picture of the economy-wide effects on exports, employment and so on, and an overall idea about whether offshore investment is, on balance, beneficial for Australia as a whole.

As locating offshore is one possible way of serving an overseas market, the next section begins by looking at the effects of ADIA on trade. ADIA is also one possible way in which Australian investment funds can be used, so the following section looks at the effects on investment within Australia. The trade and investment effects tend to explain in turn the effects on Australian employment and production patterns, and ultimately on the aggregates that affect welfare — national income and wealth. Subsequent sections discuss these flow-on effects.

The final section discusses how domestic and foreign policies might alter the effects of offshore investment. It considers measures such as investment inducements designed explicitly to influence the international location of economic activity. It also considers a range of broader policy measures that may not have been designed to affect location, but have proven influential in decisions to locate offshore. Subsequent chapters explore in more detail how the factors under government control can, or should be, changed to make offshore investments more beneficial.

4.2 Effects of ADIA on trade

Offshore investment could potentially have a number of effects on both the direction and composition of trade. It could:

- facilitate home country exports of domestic capital and other inputs involved in establishing foreign affiliates;
- facilitate home country exports of domestic inputs used in foreign production;
- displace home country exports of goods or services now being produced offshore;
- as a result, possibly increase the home country's imports of goods or services;
- facilitate exports of other finished goods to extend foreign product ranges;
- expand or displace home country exports to third countries; and
- by changing the proportion of the home country's resources devoted to other activities, have indirect effects on *all* other trade.

Firm-level effects

The Commission's survey data show that offshore investment has positive effects on Australian firms' production and trade. Indeed, 85 per cent of survey respondents indicated that locating offshore either had not changed, or had increased, the value of their production in Australia, while 86 per cent indicated that their exports from Australia had not changed or increased, and 99 per cent indicated that their imports had not changed or increased.

Significantly, these survey findings were not concentrated among firms in a few industries, but seemed to hold broadly across all industries (see Table 4.1). There were a few instances where the proportions of firms reporting an increase or no change in production were higher than average — for instance, in the non-metallic mineral products and the finance, property, business and transport services industries. These industries also had a higher than average proportion of firms reporting an increase or no change in exports.

Table 4.1: Effects of offshore investment on Australian operations, by selected industry (per cent)

	Proportion of respondents reporting an increase or no change in:		
Industry	*Production*	*Exports*	*Imports*
Mining	100	93	100
Food, beverages & tobacco	85	62	92
Textiles, clothing & footwear	58	86	100
Paper, paper products & publishing	80	80	100
Chemicals, petroleum & coal products	40	80	100
Non-metallic mineral products	100	100	100
Metal products	86	86	100
Transport & other equipment	69	85	100
Construction	100	88	100
Wholesale & retail trade	93	86	100
Finance, property & transport services	100	100	100
Average all industries	**85**	**86**	**99**

Source: IC survey.

Even in the textiles, clothing and footwear industries (which are sometimes identified as likely to decline in the face of higher ADIA), the majority of firms reported an increase or no change in both production and export levels, with the outcome for exports being virtually identical to the average across all industries. The chemicals, petroleum and coal industry reported a below-average outcome for production, despite an average outcome for exports, mainly because some firms were undergoing domestic rationalisation.

At the firm level, the nature and extent of the trade effects can depend on whether offshore investment is motivated primarily by input considerations — either the cost or the availability of inputs — or by market demand considerations.

Market demand-driven investment

For market demand-driven ADIA, market presence offshore may be seen as either necessary or desirable because it allows greater market penetration than could be achieved by exporting from Australia.

The necessity for offshore investment is most marked for services, which often need to be delivered face-to-face. Services typically also need to be tailored to individual customer needs, often making face-to-face delivery economically desirable, even when not technically necessary. In these cases, exporting in a conventional sense is simply not a realistic option — market presence is paramount. For these activities, offshore investment by definition does not replace exports, at least at the level of the firm.

Similar arguments apply for offshore investment in those manufacturing areas where the costs of transporting the finished product from Australia would be prohibitive. Pioneer and other Australian building material suppliers, such as Boral and CSR, have invested overseas in part because the bulky nature of their products makes them uneconomical to export. Pacific BBA invested offshore for a variety of reasons, but the main one was to "service the rapidly expanding domestic markets of Asia with products difficult to ship from Australia" (Sub. 1, p. 1). These areas of offshore investment are unlikely to result in reduced trade.

Other types of market demand-driven ADIA are most likely to be undertaken by dynamic, growing firms. Some of the larger ones may have limited or no opportunity to expand their business in Australia. These firms are likely to replicate various portions of their core business offshore, but not at the expense of activity levels in, or trade from, their Australian base. Their offshore investment would tend to be additional to domestic investment. It would be unlikely to reduce, and could even enhance, these firms' Australian production and trade in absolute terms. This is not to deny that some firms' Australian production and trade may have been even greater, had the investments somehow been able to be made in Australia instead.

Input-driven offshore investment

The impact of input-driven ADIA on trade at the firm level depends on whether the motivation is based on the absolute availability of inputs, or on cost considerations.

If firms are gaining access to natural resources that are simply not available in Australia, they clearly do not have the option of developing an Australian extraction facility from which to export. Offshore investment cannot be at the expense of exporting the same resource.

Some firms use offshore investment to gain access to cheaper inputs. One reason the inputs may be cheaper is because of their greater *relative* availability, although quality or accessibility might also play a role. In principle, these firms could have chosen to use more expensive inputs domestically, but it is not clear whether the goods or services produced would have been competitive on world markets and therefore able to be exported. Over the medium to long run, such offshore investment is unlikely to displace exports in a sustained way. More importantly, products from a more expensive local base would also have generated a lower rate of return for Australian shareholders.

Economy-wide effects

While offshore location may not replace exports at the firm level, the same conclusion need not apply for the economy as a whole. A single firm may invest domestic funds offshore without displacing its own exports, but the investment may have been made by shareholders at the expense of investing in some other firm's activity that had greater export potential, although (with all else equal) it was clearly perceived to yield lower shareholder returns. Nevertheless, the Commission's econometric analysis tends to support the conclusion of the firm-level survey that offshore investment does not replace exports.

The economy-wide effects are likely to depend on whether the investment is motivated primarily by input costs (perhaps reflecting relative availability), or by market demand considerations. The Commission's econometric analysis does not investigate this directly, but does find that the effects vary by broad sector (mining, manufacturing, services). For each type of motivation, there are theoretical frameworks that can shed light on the economy-wide trade implications of offshore investment.

Market demand-driven offshore investment

As discussed in Chapter 3, most ADIA is undertaken for market demand-based reasons. The BIE (1995f) found that 71.3 per cent of foreign investment undertaken by manufacturing firms and 83.1 per cent of that by service firms was motivated by market-based factors, including access to larger and more rapidly growing markets, proximity to customers, and distribution considerations. In addition, just over half of the market-based investment by service firms occurred because the growth potential in their home market was limited.

Recent theoretical approaches to market demand-driven offshore investment pay attention to its firm-level characteristics, but also trace through the implications for the economy as a whole (see Box 4.1).

The frameworks recognise that firms making offshore location decisions typically supply *differentiated products*. Even slight differences in the nature of goods and services produced in different countries provide scope for two-way flows of trade in similar products (intra-industry trade). But they can also provide scope for two-way flows of foreign direct investment, which are known to occur between countries such as Australia and New Zealand with relatively similar patterns of input availability.

Another feature of some of these frameworks is their recognition of *globalisation* — the ability of firms to break down a production or service chain into a number of stages (R&D, intermediate stages of production and sales/final assembly) and locate each stage in whichever location is most advantageous.

Splitting up a firm's production may allow certain functions to be located offshore, but at the economy-wide level this can encourage intra-industry and/or intra-firm trade at the same time as it discourages inter-industry trade. For example, if all stages of a firm's production are located in a single country, the country may trade the firm's final product for goods of other industries (inter-industry trade), or for the products of similar firms in the same industry (intra-industry trade). If the firm's sales/final assembly locates offshore, the country may no longer export the firm's finished product, but may instead export its intermediate products (intra-firm trade). When both intermediate and final production is located offshore, trade can still occur in R&D and other headquarter services.

The Commission's survey highlights the ongoing trade links of Australia's offshore subsidiaries with Australia. Only 14 per cent of respondents indicated that their offshore operations purchased no goods and services from their own business or other companies in Australia. For example, BHP sources steel feed for its overseas rolling plants from Australia, although it stated that the impact on exports from Australia went beyond this intermediate input demand.

Box 4.1: Economy-wide effects of market demand-driven investment — what does theory tell us?

In recent theoretical frameworks, the decision about whether to export from a home base, to set up plants both at home and offshore, or even to relocate entirely offshore and export back to the home market, is explained by the interplay of several forces:

- the 'public good' characteristic of knowledge-based firm-specific assets means they can be used in several plants at low additional cost;
- location advantages such as tariffs or transport costs provide an incentive to serve offshore markets from offshore plants; while
- traditional economies of scale arising from fixed costs per plant create a countervailing incentive to concentrate production in a single plant location.

The plant-level economies of scale partly explain why firms typically expand in their home market before venturing offshore. Significant transport costs and economies of multiplant operation then help to explain why firms may seek offshore market opportunities once domestic growth opportunities have declined.

The economy-wide implications for trade depend on the allocation of labour between these sectors with differentiated product characteristics and other sectors in the economy. In the differentiated product sectors, knowledge-based assets are the basis for employment, while other sectors are characterised as producing homogeneous products and using inputs such as land as the basis for employment. Differentiated products often require a number of stages of production — R&D, intermediate stages of production and sales/final assembly. When offshore location decisions can be made for each stage separately, the economy-wide trade implications also depend on which stages of production are undertaken domestically and/or which are undertaken offshore.

When offshore location occurs as a natural response to changing comparative advantage among countries (arising from dynamic changes in input availability, in transport costs, and in firm and plant level economies of scale), it can be associated with a change in the nature of trade (intra-industry and intra-firm versus inter-industry) as much as with a change in its volume. The exact outcome for trade volumes is ambiguous. Only in the limit of having multiple locations of each and every stage of production would trade tend to be completely suppressed. However, this would require the advantages of proximity to dominate the advantages of concentration up and down the production chain. It would also require the absence of significant differences in technology or input availability that would encourage more traditional motives for specialisation and inter-industry trade.

Sources: Brainard 1993a, Ethier 1986, Horstmann and Markusen 1992 and Markusen 1995.

The available aggregate data also confirm that at least some of Australia’s offshore investment is concentrated in countries with which we have a relatively high share of intra-industry trade. Bora (1996) reveals that three of the top four destinations for ADIA (*relative* to their importance as sources for the rest of the world) are also Australia’s top three intra-industry trading partners — New Zealand, Indonesia and Singapore.[1]

Thus, in principle, offshore location is likely to be associated with a change in the nature of trade (intra-industry and intra-firm versus inter-industry trade), although the exact outcome for trade volumes is unclear.

1 Australia also has relatively similar input availabilities to some of these countries. Bora shows that, like Australia, New Zealand and Indonesia have a revealed comparative advantage in agriculture, while Indonesia also shares Australia’s revealed comparative advantage in minerals.

A further distinction that has attracted interest in the literature is whether offshore investment is designed to serve the local market, or instead to serve third markets. The latter category of offshore investment is clearly trade-enhancing in a global sense, although the immediate impact is to raise the exports of the host country rather than Australia. To the extent that increased exports to third markets are part of a pattern of growing globalisation, this type of offshore investment may indirectly increase total Australian exports.

Overall, market-demand driven offshore investment may reduce some types of trade but encourage others. To the extent that market demand-driven offshore location reflects increasing globalisation of economic activity, its overall effect on trade volumes is more than likely positive.

Input cost-driven offshore investment

Survey evidence suggests that, with the exception of mining investment, only a small proportion of ADIA is motivated primarily by differences in the cost or availability of inputs (see Chapter 3). The BIE (1995f) survey found that input-related reasons — either gaining access to natural resources or obtaining cheaper inputs — were the primary motivation of only 16 per cent of manufacturing and service firms. As noted earlier, one reason inputs may be cheaper overseas is because of their greater *relative* availability.

At a theoretical level, the distinction needs to be made between input costs that are lower because of greater relative availability, and input costs that are lower because of differences in production technology. Both sources of difference in input cost can motivate trade as well as capital flows.

Traditional trade frameworks suggest that when input cost differences reflect differences in relative input availability, the trade and capital flows that are generated can be substitutes — increasing one reduces the other. However, where input cost differences reflect differences in production technology, the trade and capital flows generated can be complements — increasing one increases the other (see Box 4.2).

It is difficult to distinguish the different types of trade and capital flows directly, but indirect evidence on the relative importance of differences in production technology or relative input availability can help to identify which type of effect is likely to dominate.

Differences in production technology appear to be more important for mining firms and selected manufacturing firms. For example, many Australian mining companies invest offshore to gain access to higher quality and/or more economically viable resource deposits than are available in Australia. The greater quality or prospectivity of offshore deposits essentially facilitates a superior production technology. Similarly, Edwards (1994) and AEEMA (Sub. 16) found some evidence of companies investing overseas to acquire technology not available in Australia. If production technology is the source of the input cost differential, then such offshore investment is likely to enhance the overall volume of trade.

On the other hand, the evidence suggests that clothing and footwear companies have invested offshore to gain access to labour that is cheaper because of its relative availability. For example, Pacific Dunlop invested in China and Mark One Apparel in Fiji, in both cases taking advantage of significantly lower labour costs than in Australia.

At the firm level, it is unlikely that Australian production of low value-added clothing or footwear manufactures would remain viable in the long term in any event, given large labour cost differentials. Hence, preventing offshore investment by clothing or footwear firms would not help to preserve production or exports in the clothing and footwear industries, even though it might contribute slightly to a greater volume of trade for the economy as a whole.[2] Neither would it reduce the need for structural adjustment in those industries.

Box 4.2: Economy-wide effects of input cost-driven investment — what does theory tell us?

Traditional frameworks that examine the implications of trade in goods and services give insights into the economy-wide implications of input cost-driven offshore investment.

Differences between countries — whether in relative input availability, in production techniques or in relative preferences for particular products — generally provide an incentive for specialisation in production, and the opportunity for trade that leaves both sides better off. The diversity tends to generate differences in input costs and output prices, providing the signals for gainful trade.

When capital flows are motivated by input cost differences, they can supplement the gains from trade. However, they may amplify or dampen the volume of trade itself, depending on the nature of the differences between countries.

The Heckscher-Ohlin framework focuses on one source of difference — the relative availability of inputs — as the factor motivating trade in goods and services across national borders. When countries differ in input availability, they will tend to export the goods and services that use relatively intensively their abundant inputs. Such trade tends

2 Theory suggests that such offshore investment (motivated by input cost differentials reflecting relative input availability) would tend to substitute instead for exports of capital-intensive goods.

indirectly to narrow the differences in relative input availability, in the process bringing input prices closer together. Since capital flows make relative input availability (and hence input prices) more equal directly, capital flows will substitute for this type of trade in goods and services — an increase in capital flows will *reduce* the volume of trade.

Trade which arises for other reasons, however, need not be reduced as capital flows increase. Trade can be motivated by differences in production technology, or by a range of other factors — increasing returns to scale, the presence of a monopoly producer or government-induced distortions.

Trade motivated by such factors does not tend to equalise relative input prices. For example, a technological advantage that allows one country to produce goods or services using fewer inputs than in other countries, also allows it to pay at least some of those inputs more than other countries, even when output has the same (world) price. Input cost-driven capital flows still help to equalise input prices, while trade does not. Trade and capital flows have different effects and, in this sense, do not substitute for each other. Indeed, the capital flows will tend to provide a motivation for extra trade (Markusen 1983) — increasing capital flows will *increase* the volume of trade.

Helpman (1984, 1985) and Helpman and Krugman (1985) come to a similar conclusion concerning the complementary relationship between input cost-driven capital flows and trade, in a framework that also takes account of ownership advantages distinguishing direct investment from other forms of investment.

Empirical evidence and assessments of trade effects

Empirical studies, described in some detail in Appendix E, generally find that the effects of foreign investment on trade vary:

- between types of goods (for example, raw materials and finished products);
- according to what is assumed to happen in the absence of foreign investment; and
- according to whether the output of the industry undertaking the investment can be traded.

Some of the studies examine only direct or firm-level effects, while some examine effects for the economy as a whole. The Commission has been unable to identify many studies based on Australian data. However, it has reviewed overseas studies with a view to identifying the implications of their findings for Australia.

Exports

At the firm level, the literature unanimously finds that foreign investment has a positive effect on once-off exports of capital and other inputs used in establishing the foreign subsidiary, and on exports of raw materials and processed intermediate inputs on a continuing basis.

One area where foreign investment may have an adverse trade impact is in finished goods that were initially exported but are now also produced overseas. This clearly depends on what would have happened to the exports in the absence of foreign investment. Given that many services are effectively non-tradeable, the empirical literature focuses primarily on the manufacturing sector.

Several US studies pay particular attention to the counterfactual, by estimating the extent to which American manufactured exports could have supplied foreign markets. They compare the difference in the (variable) cost of production at home and abroad, taking into account the cost of transportation and the sensitivity of foreign demand to any change in prices.[3] However, they do not take into account the more intangible benefits of offshore location, such as market responsiveness, that can make investment a more viable option than exporting. The studies find that American foreign investment, to varying extents, has had a negative impact on exports by manufacturing industries.

Some surveys of manufacturing firms broadly support this conclusion, at least in the short term. For example, Shepherd, Silberston and Strange (1985) found that approximately half of the British firms surveyed could have supplied foreign markets to some extent through exports. Edwards and Buckley (1995) found for Australian firms, however, that the longer-term effect of offshore investment on exports is likely to be positive, as foreign investment helps firms to achieve greater market penetration than could be achieved solely through exporting.

Even if foreign markets could be supplied through exports, some foreign investment may be needed in sales, service and distribution facilities in the host country. Bergsten, Horst and Moran (1978) found an initial positive association between foreign investment and exports in manufacturing, with exports then declining beyond a certain point.

Econometric studies of manufacturing firms, however, find little support for the notion that foreign investment substitutes for exports of finished goods. Such studies typically correct for a range of other possible influences on export performance. If anything, they suggest a positive relationship between foreign

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3 See Frank and Freeman (1978) and Glickman and Woodward (1989). Appendix C of the latter study provides a more detailed explanation of the methodology.

investment and exports, although most are incapable of identifying whether the finished goods being exported are the same as those being produced offshore. The Commission's econometric analysis for Australia also finds a positive relationship for manufacturing, as well as for mining and services (see Appendix F).

Those studies assessing the aggregate effect of foreign investment on exports from all sectors, not just from manufacturing, also find an overwhelmingly positive relationship. That is not to say that some displacement may not have occurred, just that the induced exports have more than offset them.

Imports and the current account

Relatively few studies focus on the effects of offshore investment on imports and the current account. The literature finds a weakly positive relationship between imports and outward foreign investment. However, those studies do not differentiate between the categories of goods being imported (for example, intermediate inputs and finished goods). The Commission's econometric work also finds a positive relationship at the economy-wide level (see Appendix F).

None of the empirical studies look at the complete implications of foreign investment for the current account at the margin (although in total, a country that is a net capital importer must by definition have a current account deficit). However, some studies shed light on two key aspects of the current account impact. Although far from conclusive, some studies indicate that, if anything, foreign investment tends to improve net export performance (see Appendix E). Other studies explore the time taken for the income flows from foreign investment to cover the net cost of the project. Although somewhat dated, these studies find that it takes 9 to 12 years on average for the investment to generate a positive net return. These studies ignore the indirect trade effects, except for the exports of capital associated with the initial investment.

Summing up on trade effects

Theoretical frameworks suggest that in a world of increasing globalisation, the trade effects of market demand-driven offshore investment are most likely positive. Some input-cost driven investment is likely to increase trade volumes, while some will decrease overall trade volumes, particularly when the input cost differences reflect differences in input availability. The available evidence suggests, however, that market-driven offshore investment is the major component of offshore investment, while input-driven investment is a minor component. The balance of the arguments is therefore that offshore investment will have a positive impact on overall trade volumes.

The empirical evidence tends to confirm that while offshore investment may replace some types of trade at the firm level, the overall impact on trade volumes (both exports and imports) is positive. Available evidence on net export performance is weaker, but also tends to be positive.

4.3 Effects of ADIA on total investment

The effects of offshore investment on domestic investment also have attracted attention in the literature. The Australian Stock Exchange addressed the issue as follows:

> Does overseas investment mean less domestic investment? This issue cannot be divorced from the broader economic context. The rates of return on investment may be larger on investments abroad than on domestic investments. Domestic and overseas operations may have to compete for limited funds. On the other hand, earnings from successful investments are an important source of funds for future investment including on the domestic front. The relationship between domestic and overseas investments is a complex one which requires further study (Sub. 6, p. 2).

At the firm level, any ADIA that took place at the expense of viable local production would reduce the firm's investment in its local plant facilities, for maintenance or expansion purposes. Some types of input-driven offshore investment may have this effect, although when ADIA is driven by particularly large input cost differentials, it is not clear that local production facilities would be viable in any event.

When ADIA is market demand-driven, it tends not to be at the expense of local production. Unless firms are capital-constrained, it should not therefore be at the expense of local investment.

BHP said explicitly that it was not presently capital-constrained, so that its offshore investment would not crowd out local investment:

> It is sometimes implied that Australian investment offshore takes place instead of domestic investment, to the detriment of Australian production and employment. This is not necessarily the case, and is certainly not the case in respect of BHP's investment. We are perpetually seeking investment opportunities which meet our investment criteria, and at present we are not capital constrained provided projects meet those criteria. It is meeting those investment criteria which limits our investment in Australia (or anywhere else); it is highly unlikely that an Australian investment proposal would be rejected solely on the grounds that we were already committed to other investment overseas (Sub. 15, p. 16).

The MTIA's survey (Sub. 9) found differing views on the impact on domestic investment of firms locating offshore. Some companies stated that their offshore investment occurred at the expense of domestic investment. Others said that domestic investment would still continue, but in the form of maintenance investment rather than investment in new manufacturing. It is not clear whether such domestic opportunities were forgone because they failed to meet a threshold rate of return criterion.

The Commission's own survey was consistent with BHP's view, although the complementarity of offshore investment with domestic investment was slightly less strong than with production or exports — 79 per cent of survey respondents indicated that offshore investment had increased or not changed their level of domestic investment.

As before, however, the firm-level effects do not necessarily translate to the economy as a whole. What distinguishes Australian firms locating offshore is that they retain some control via a sufficient equity stake. At the level of the economy as a whole, and over the longer term, an Australian equity stake can only be maintained for investments funded out of Australian savings (including the undistributed profits of Australian subsidiaries offshore).

If the pool of domestic savings were limited, or affected only indirectly by the uses to which the funds were put, investing those savings offshore would tend to preclude the use of domestic savings in some domestic alternative. (A possible exception is where offshore location uses only the 'free' firm-specific assets already acquired by past investments that can be utilised offshore without reducing the amount available at home.) But this is not to say that the domestic alternative investments could not be funded by foreign funds flowing into Australia. In other words, Australian firms' offshore investment *may* be at the expense of domestically-funded investment in Australia, but it need not be at the expense of total investment in Australia.

Empirical evidence on investment

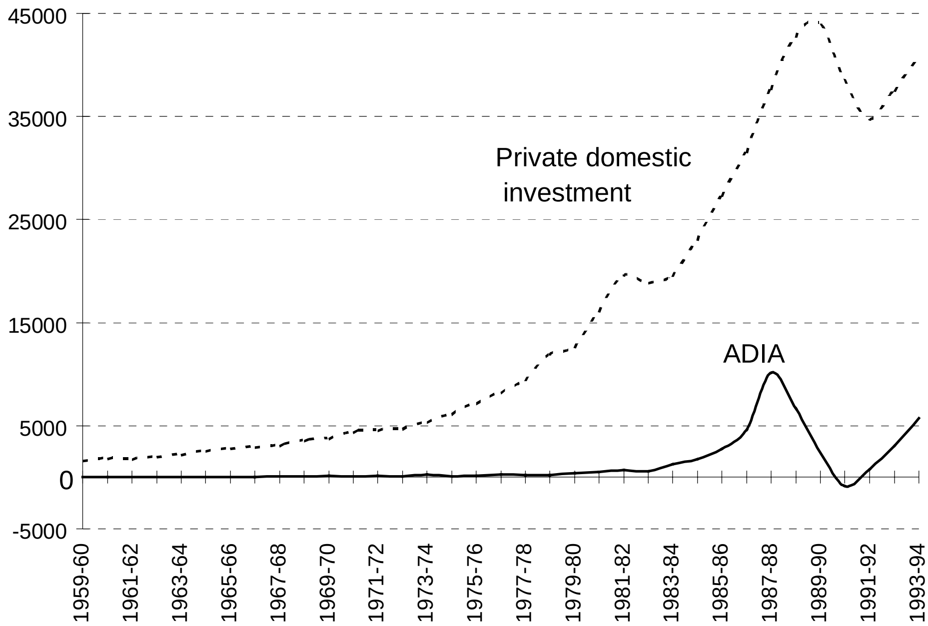
As noted, the Commission's survey tends to find a positive relationship between ADIA and total investment in Australia. So too does the BIE (1995f).

One of the significant foreign studies in the area comes to the opposite conclusion. Feldstein (1994a) found that foreign investment by OECD countries reduced domestic investment by an equal amount, and was not offset by an increase in international portfolio investment. His conclusion is consistent with the idea that both domestic and foreign investment have to be financed solely or primarily out of domestic savings. However, Rao, Legault and Ahmad (1994) estimated a positive and statistically significant relationship between outward foreign direct investment and domestic investment for the United Kingdom, Germany and Japan.

A simple comparison of ADIA with private investment in Australia (see Figure 4.1) suggests a complementary relationship at the economy-wide level, with both domestic and offshore investment being affected by general economic conditions. A comparison of ADIA with Australian private savings gives a similar picture, although the complementary relationship is slightly less strong.[4]

This tends to suggest (though not conclusively) that outward investment is not at the expense of total investment, or of domestically-funded investment. If offshore investment is undertaken because it is highly profitable, it is quite likely that it will generate enough additional income or wealth for Australians to raise their savings levels as well. Available empirical evidence suggests that offshore investments tend to be more profitable than domestic alternatives (see Chapter 2 and Appendix E). The Commission's survey indicates that 72 per cent of respondents found that offshore operations had increased the overall profitability of their operations. A number of American studies also found that profitability and offshore investment were positively correlated.

Figure 4.1: Domestic private investment[a] and ADIA, 1959–60 to 1993–94 ($ million)



a Private gross fixed capital expenditure on non-dwelling construction and equipment.

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4 Over the period 1959–60 to 1993–94, the correlation between ADIA and private domestic investment is 0.70, whereas over the period 1982–83 to 1992–93 the correlation between ADIA and private national savings is 0.37. The correlations between corresponding data in first difference form are 0.36 and 0.27.

Sources: ABS, Cat. Nos. 5204.0, 5206.0, 5221.0 and 5363.0.

The comparisons also suggest that any gaps in the funding of worthwhile domestic investments tend to be covered by inward foreign investment. Although the chapter has so far ignored the flow-on effects of such ‘replacement’ inwards investment, it has an important additional influence on Australian trade, employment and production patterns, and therefore on national income and well-being. The Commission’s econometric analysis confirms that both inward and outward investment have a significant and positive relationship with the investment by Australians in Australia.

4.4 Effects of ADIA on employment levels, wages and employment composition

At the firm level, the employment implications of direct investment abroad tend to mirror the trade implications.

When firms invest offshore for market demand-based reasons, it is possible for their domestic employment levels to be maintained, or even to increase, in line with domestic production levels. In the Commission’s survey, 51 per cent of respondents indicated no change in Australian employment levels, while a further 32 per cent indicated that employment levels had increased. In addition, 34 per cent noted that offshore location had also been associated with a change in the composition of their workforce in Australia.

If offshore investments are designed instead to gain access to natural resources not available in Australia, such investment cannot be at the cost of employment opportunities in some comparable resource extraction facility at home. Where firms are investing offshore to gain access to cheaper inputs, they could have chosen, in principle, to use more expensive inputs at home. However, for the same reason that exports from such a local production base may not be competitive, the employment created in such a local production base may not be viable in the longer term.

Employment levels

The empirical literature (see Appendix E) acknowledges that foreign investment simultaneously creates and displaces domestic employment across the economy. The overall impact is seen to depend on the relative strengths of these two countervailing effects.

Some studies find that foreign investment enhances domestic employment because the ‘job creation’ effect exceeds the ‘job displacement’ effect, while other studies find the converse. However, many of the techniques used are incapable of separately measuring these effects. Those studies that do measure these relative effects suffer from other methodological deficiencies that cast significant doubt over their findings.

Most of the American studies assume that, in the absence of foreign investment, *all* of the funds invested overseas would have been invested in the United States. As a direct result of this assumption, these studies find adverse employment effects. The more rigorous studies test the sensitivity of their findings to the key assumptions used (for example, the share of foreign production destined for the home market). Their findings are sensitive to the values used — in many cases changing an apparent loss to a gain. Other studies, such as Edwards (1994) for Australia, impute positive outcomes for employment from their positive findings for exports.

The impact of foreign investment on employment depends on what would have happened if the investment had not taken place. Where foreign investment opens up new markets, the employment effects are clearly positive. Several studies find this to be the dominant impact within the services sector.

The employment implications for manufacturing industries are also related to the trade effects discussed previously. Where foreign investment complements domestic exports, domestic employment is likely to be higher than it would otherwise have been. However, this has not been proven conclusively. Using a small survey of manufacturing firms, Buckley and Artisien (1987) conclude that when foreign investment complements trade, there is no discernible effect on domestic employment. Other firm- and industry-level studies of manufacturing find that, where foreign investment replaces domestic exports, the employment effects are clearly negative. However, none of these studies addresses the issue of whether exporting could be sustained in the long term. Shepherd, Silberston and Strange (1985), whose survey found that domestic exports could have supplied foreign markets to some extent, doubted whether such exports could be sustained in the long term in the presence of foreign competition. If exporting could not be sustained, then unemployment would have occurred anyway, albeit at some future date.

The literature suggests that most, if not all, of the unemployment associated with foreign investment is likely to be transitory, rather than permanent. In one (now dated) study, Frank and Freeman (1978) found that most of those made unemployed by American manufacturing foreign investment found employment within seven weeks. They concluded that protracted periods of unemployment were not one of the major effects associated with the transfer of production activities overseas. Given the significant differences in flexibility between the American and Australian labour markets, it is not clear whether these conclusions apply to Australia.

At the economy-wide level, the employment effects of outward and inward direct investment on aggregate employment in the United States have been described as follows:

> *The net impact of FDI on US employment is approximately zero*, and the truth of this assertion has nothing to do with job gains and losses estimated at the industry level (Graham and Krugman 1989, p. 49, emphasis in original).

The point being made is that whether the industry-level job gains and losses translate into significant changes in overall employment levels has more to do with the adjustment process than with the offshore location decision itself.

The Commission's econometric analysis finds a significant positive relationship between offshore investment and employment at the economy-wide level. While the Australian labour market may not have been as flexible as the American market in adjusting to offshore investment, the market expansion effects of offshore investment appear sufficient to ensure that the overall employment effects are positive.

Wages

The empirical literature sheds little light on the effect of offshore investment on wage levels and the share of national income accruing to labour (see Appendix E). However, the theoretical frameworks that help to explain the economy-wide implications of market demand-driven investment provide several reasons why offshore investment can lead to *higher* wages in Australia. The evidence is that the bulk of offshore investment is driven by market demand considerations rather than by input costs.

The success of market demand-driven offshore investment will tend to expand the Australian employment base of the investing firms. The workers in those firms can share in the returns from the firm-specific assets that help make the offshore investment a success. The wage floor for those not sharing such returns can also be raised, irrespective of their skill level, through lower labour intensity and increased labour productivity in other sectors of the economy, where wages are still set competitively (see Brainard 1993a, for example).

In addition, to the extent that *direct* investment in offshore locations is a way of protecting R&D investments that produce firm-specific assets, it can provide a mechanism for ensuring more R&D is undertaken. If, in turn, one of the payoffs to R&D is the production of higher quality products at a lower real resource cost, this could have payoffs in real wage terms in both source and host countries (Ethier 1986).

By contrast, the trade frameworks that give insights into the economy-wide implications of input-driven capital flows suggest that, to the extent that offshore location leaves capital stocks lower than otherwise in at least some domestic industries, it will result in a lower return for at least some other inputs, which might include labour. However, input-driven investment is not a major component of ADIA. It is also important to remember that Australia is a net capital *importer*, and to the extent that offshore location encourages replacement inflows of capital from overseas, this could offset any impact of offshore location on wages. The frameworks that help to explain the economy-wide implications of market demand-driven investment confirm the possibility of replacement capital inflows and two-way direct investment, even in the same industry.

Employment composition

The Commission's survey confirms that offshore location can affect the composition of the workforce, even within the firms making the offshore investments. The 34 per cent of respondents that indicated a change in composition of their workforce in Australia were split between manufacturing and service operations in a ratio of roughly two to one.

- Within those manufacturing operations, 55 per cent noted an increase in R&D/engineering employment, around 35-42 per cent noted an increase in employment in marketing/sales and management/administration, while around 32-39 per cent noted a *decrease* in skilled or semi-skilled production employment (see Table 4.2).
- Of those service operations reporting a change in workforce composition, the most notable feature was that 71 per cent reported an increase in employment in management/administration. Between 19 and 56 per cent reported increases in other employment categories. Instances of employment decreases were far fewer than in manufacturing.

Table 4.2: Effect of offshore investment on the composition of employment in Australia[a] (per cent)

	Manufacturing			*Services*		
Employment category	*Increase*	*No change*	*Decrease*	*Increase*	*No change*	*Decrease*
R&D/engineering	55	29	16	31	63	6
Skilled production	16	52	32	38	62	0
Semi-skilled production	13	48	39	19	81	0
Marketing/sales	35	49	16	56	44	0
Management/administration	42	42	16	71	17	12
Other	11	89	0	38	49	13

a Among firms reporting a change in overall workforce composition.
Source: IC survey (see Appendix D).

This survey evidence provides some indication that offshore location creates pressures for skills upgrading, at least within manufacturing, as argued in UN (1993a). The limited overseas studies undertaken in the area also find that foreign investment either benefits, or has a less adverse effect, on the demand for more highly skilled labour. Those employed in head office functions (so-called ‘white collar’ jobs) gain relative to production workers (so-called ‘blue collar’ jobs) and even within blue collar occupations, foreign investment seems to favour the more skilled.

The Commission’s survey evidence also suggests, however, that some of the upgrading in manufacturing is occurring *within* firms, with additional R&D, sales and management positions being created in the same firms that are shedding production jobs. Depending on the management skills of those companies, containing the adjustment within the firm may help to reduce any adjustment losses from the community’s viewpoint. But, as noted earlier, offshore investment is only one, relatively minor, source of pressure for labour market adjustment:

> As long as employment opportunities are expanding — an issue that goes well beyond the narrower scope of FDI — the real issue is whether FDI accelerates the adjustment process for workers moving from one set of jobs to another ... Whether FDI contributes to the efficiency of the adjustment process depends on product-cycle considerations (whether the TNCs [transnational corporations] are technologically dynamic), macroeconomic processes, institutional support and the nature of the educational system. No simple generalisations can apply across industries, periods or countries (UN 1993a, p. 70).

The Australian Business Chamber expressed concerns about the effects of offshore investment on labour market adjustment in general and low-skilled employment in particular:

> One observation that needs examination is the proposition that Australian companies moving offshore somehow transform the jobs at home into high skill jobs. Without investment at home it is difficult to accept this proposition (Sub. 41, p. 1).
>
> The Industry Commission needs to be challenged on this assumption that an increased demand for skilled labour is a positive outcome of firms relocating offshore (Sub.41, p. 2).

As noted in the previous section, offshore investment typically has been complementary to private investment in Australia at both the firm and the economy-wide level. Since domestic investment tends to increase as offshore investment takes place, it follows that offshore investment can be associated with job transformation rather than job loss at home. However, maximising the benefits of offshore investment is predicated on a dynamic economic environment, free from impediments that might prevent such transformations taking place.

Summing up on employment

At the sectoral level, foreign investment can generate both positive and negative employment effects. Where foreign investment opens up or expands markets (as in services and non-tradeable manufacturing), the employment effects are likely to be positive. Such market demand-driven offshore investment accounts for most offshore investment in Australia. Where foreign investment displaces trade (as in some types of tradeable manufacturing), the short-term employment effects are likely to be negative, although the long-term effects are unclear. Exporting may not be a viable long-term option, especially in the face of large labour cost differentials. If exporting were unsustainable in the long term, the negative employment effects would occur in the future anyway. If so, offshore investment would affect the timing of the impact, but not the impact per se.

The economy-wide effect on employment depends on a range of institutional and other factors, as much as on offshore investment itself. The theoretical evidence suggests that the impact of offshore investment on wages is more likely to be positive than negative. The empirical analysis supports this conclusion.

The Commission has been asked about policies that might serve to enhance domestic skilled employment, value adding activities and production. The Commission has found that offshore investment tends to create its own impetus for skills upgrading. Within manufacturing, this is sometimes at the expense of lower-skilled production jobs, but the adjustments to this appear to be capable of being dealt with in part within the particular firms involved.

Ultimately, the real issue is about labour market adjustment. The effects of offshore investment are likely to be minimal relative to ongoing adjustment pressures from technological and market change. If adjustment to such changes is slower than it should be, the most appropriate response is to address any policy-related sources of rigidity.

4.5 Effects of ADIA on production, including spin-off benefits

The Commission's survey findings are that the implications for the production levels of the firms making the offshore investments are predominantly neutral or positive. This is supported by the Commission's econometric work.

As noted, this finding is not concentrated among firms in a few industries, but seems to hold broadly across all industries. This, and the fact that changes in the composition of employment tend to be concentrated within firms rather than across sectors, suggests that offshore investment is unlikely to create major changes in the composition of production. However, a significant share of offshore investment is undertaken by service firms, and supports the growth of these firms. Offshore investment may therefore support the longer-term trend towards the increasing significance of the services sector to the Australian economy.

The predominantly neutral or positive effect of offshore investment on production levels may simply reflect the evidence seen already concerning the effects on trade, domestic investment and employment levels. But it would also reflect the impact of any additional spin-off benefits of offshore operation on these firms' operations at home.

The Commission's survey showed that just over 50 per cent of respondents reported some type of technological or related benefit to their operations in Australia. Benefits in the areas of R&D, production/process technologies and marketing were those most often cited. Firms in the chemicals, petroleum and coal products and the non-metallic mineral products industries were more likely to receive such spin-offs.

The BIE (1995f) found stronger evidence of spin-off benefits flowing to Australia from foreign investment than did the Commission. Its survey found that 78 per cent of respondents gained some form of spin-off benefit. The service sector attached slightly greater significance to them than did manufacturing firms. Most of the spin-off benefits were in the form of R&D capabilities, new production technologies, new products and new management practices. At the same time, 82 per cent of firms did not experience any adverse effects. Those firms that did experience some loss of proprietary knowledge had their products and production processes copied by foreign rivals.

As noted by the BIE (1995f), firms which tap into 'national advantages' in the host country can receive spin-off benefits that supplement and strengthen their firm-specific assets. Learning to operate within different environments and policy regimes can also provide more general benefits, in terms of skills as well as technology (UN 1993a).

Some of the Commission's visits and submissions also noted possible spin-off benefits of offshore location (see Box 4.3). However, benefits were not universal. AMP said that it gained no technology transfer benefit from offshore investment, while one large manufacturing firm suffered a spillover cost from locating offshore, with some technical knowledge being obtained illicitly by a competitor. In the MTIA's survey, companies cited China and Korea as countries in which they would not conduct business until intellectual property was given protection.

Box 4.3: Spin-off benefits from offshore investment

BHP argued that it deploys management, technical and operational skills from partners and peers throughout the world in its Australian operations, thereby making its Australian operations more efficient.

QBE insurance found that the spin-offs from locating offshore included improved management philosophy (in particular less 'insular' management) and better planning procedures.

Wattyl also found that its offshore operations provided it with technical spin-offs. It benefited by being more aware of the development of new products and was better informed about new developments.

Pacific Dunlop gained significant intangible benefits, such as knowledge transfers, from offshore investments.

4.6 Effects of ADIA on taxation and the treatment of repatriated profits

Profit repatriation

The Commission's survey shows a trend towards reinvestment rather than repatriation of offshore profits. For example, 63 per cent of respondents said they repatriated less than 25 per cent of profits, while 22 per cent of respondents said they repatriated over 75 per cent of profits.

These figures imply relatively high rates of reinvestment, compared with the Australian average. Aggregate dividend payout ratios in recent years for private sector companies, constructed from Australian Stock Exchange data, have been 70 to 80 per cent of earnings. In the case of industrials, the payout ratio has been between 80 and 90 per cent of earnings (BIE 1993).

However, it is unclear whether the rate of reinvestment of offshore profits is any greater than might have been expected from dynamic, growing companies, as those engaging in market-driven offshore investment appear to be.

Currently, when offshore profits are reinvested they are not measured as part of Australia's national income (ABS 1990, p. 284).[5] However, reinvested profits add to the wealth of Australians, and can generate realised income when repatriated in the future. And since offshore investment is undertaken generally because it is expected to yield a higher return, the impacts on national income and/or wealth will tend to be larger than if the investment had been made at home.

The policy issue is whether there are any distortions affecting the willingness to repatriate. Some firms indicated that there were some distortions. In the Commission's survey, 63 per cent of respondents said there were no problems in repatriating profits, but 21 per cent said foreign government restrictions affected repatriation, while 9 per cent stated that Australian tax policy influenced the degree of repatriation of profits. Chapter 10 discusses in more detail foreign government restrictions that apply to the repatriation of profits.

Taxation treatment

When profits are repatriated, they may incur company tax in Australia. The Australian Taxation Office cannot distinguish different types of net foreign

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5 It is a United Nations (UN 1995) recommendation that they should be, although the additional income inflow would then also be recorded as an immediate capital outflow back to the host country. According to the ABS, Australia has not yet finalised its position on whether to adopt the United Nations recommendation.

income subject to company tax (income from some direct offshore investments, income from portfolio investments, foreign capital gains, and even income earned overseas by service firms without having necessarily established a permanent foreign presence). In total, however, just over $3 billion in foreign-earned income was liable for Australian company income tax in 1993–94. At the 33 per cent corporate tax rate then prevailing, and allowing for the $140 million in foreign tax credits, this foreign income would have generated up to $850 million in company income tax in Australia.

The overwhelming majority of profits from direct offshore investment are exempt from company tax because they have been earned in a so-called ‘listed’ country with a tax system similar to that in Australia. (Some listed countries also have reciprocal arrangements whereby they exempt from company tax the profits repatriated to them from their subsidiaries in Australia, after the subsidiaries have paid Australian tax.) The Australian Taxation Office does not keep records of the amount of foreign-earned income exempt from company tax for this reason. However, the Australian tax system provides that all foreign-sourced income is fully taxed at the shareholder level. (The dividend imputation system only gives credits for Australian company taxes.)

The base on which individual tax payments are paid will be slightly lower than if the earnings had been generated in Australia, because the income tax base is net of taxes paid in the foreign country. However, the profits from offshore investments are also expected to be higher than if earned at home.

When profits are not repatriated, they are capitalised into the value of the shares held by Australian shareholders, and subject to capital gains tax when the shares change hands.

Thus, the current tax system works to ensure that, one way or another, the profits from offshore investment generate appropriate tax revenue in Australia. To the extent that there are problems with the taxation treatment of profits from offshore investment, these are discussed in more detail in Chapter 5.

4.7 Effects of ADIA on national income

The overall impact of offshore investment on national income is determined essentially by the impact on wages and employment on the level and profitability of domestically-funded investment in Australia, and on the level and profitability of net foreign investment (offshore investment net of any inwards ‘replacement’ foreign investment).

Earlier sections have noted that a firm investing offshore is likely to expect a higher return than on domestic investments, since this is needed to outweigh some of the sources of competitive disadvantage faced by domestic firms in an offshore environment. Thus, the profits from offshore investment should be sufficient to offset any lower profits from a lower level of domestically-funded domestic activity.[6] As noted earlier, the profits from offshore investments count as part of national income once they are repatriated. If they are reinvested, they add to Australia's wealth and capacity to generate higher income in the future.

Significant amounts of offshore investment could have the potential to change wages and the composition of employment, particularly by changing the nature and extent of the activities undertaken domestically. But theoretical and empirical evidence identifies several reasons why offshore investment can be beneficial to employment and wages. The features that make firms successful in offshore markets (firm-specific assets and spillovers) also make them profitable in domestic markets, and these benefits can be shared with labour. Secondly, any investment gaps created by offshore investments can be filled by replacement inwards investment from overseas. Indeed, some types of offshore investment may encourage additional capital inflows, which not only generate tax revenue, but can also benefit wages and provide employment opportunities. (It can also benefit Australia by providing additional competition at home.[7]) For both these reasons, offshore investment can be beneficial to Australian employment and wages.

Overall, therefore, offshore investment can be expected to increase national income and enhance the wealth of the Australian community. There do not appear to be serious adverse consequences that need to be addressed with policy measures. Instead, the appropriate policy response is to find ways of making offshore investment even more beneficial. This is the theme of the next section.

4.8 Effects of ADIA in the presence of policy distortions

Previous sections assessed the economic effects of ADIA, taking into account features that motivate offshore investment and preconditions that make it worthwhile. However, the discussion generally abstracted from the influence of

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6 Horstmann and Markusen (1989) show that when offshore production replaces exporting from a local production base, the additional profits will also be sufficient to offset the loss associated with taking less advantage of economies of scale in the home plant. They also show that, because offshore location avoids tariffs or transport costs, it could provide a better terms of trade than exporting.

7 Brainard (1993a) and Ethier (1986) discuss the likelihood that inward foreign investment will expand product choice. Strategic interaction between a local and foreign competitor at home can still lead to a less than socially optimal outcome (Horstmann and Markusen 1992), although this is an issue for domestic competition policy.

government policy on ADIA. Where policy distorts investment decisions, it can also alter the effects of ADIA on the economy as a whole.

Policy distortions can have two major implications for the economic effects of offshore investment:

- Policy distortions may alter the relative profitability of particular projects or limit the range of investment opportunities available. This may directly influence a firm's decision to invest offshore, and lead to a different level and pattern of ADIA.
- Policy distortions may impede the efficient operation of markets by preventing markets from adjusting once the investment has occurred. This may alter the magnitude and/or distribution of the resulting effects from a given offshore investment.

This section is concerned with how Australian or foreign government factors may influence the economic effects of ADIA. It begins by discussing the effect of foreign government distortions. It then looks at domestic distortions, and whether the appropriate policy response is in terms of influencing offshore investment or addressing the distortions directly.

Foreign policy distortions

As noted previously, overseas government policies may affect ADIA directly or indirectly. These 'foreign distortions' can be categorised in terms of 'pull' or 'stop' factors. A foreign government may initiate a policy, such as a tax incentive, which increases the relative profitability of overseas production and thereby pulls investment towards the overseas market. Alternatively, foreign policies such as foreign investment controls may discourage or stop foreign investment from flowing to a particular industry or country.

The major categories of foreign distortions which can affect the impacts of ADIA are tax and other investment incentives, tariffs and other trade barriers, and foreign investment controls.

- Many countries offer *incentives* for foreign firms to locate within their jurisdiction (see Chapter 10). Incentives include tax incentives (such as tax holidays, investment allowances, tax credits and reduced tax rates) and other financial incentives (such as grants, preferential loans, loan guarantees, tariff concessions and priority access to credit). Among the 45 per cent of respondents in the Commission's survey for whom factors subject to foreign government control had an influence on the decision to invest offshore, 31 per cent indicated that tax incentives were the most important factor.

- Tariffs and other *trade barriers* (such as import quotas and local content schemes) imposed by foreign governments also affect a firm's trade and investment decision by pulling investment towards the offshore market. Of the survey responses in which foreign government factors had some influence, 20 per cent mentioned trade barriers as being the most important factor.
- Many other foreign government factors have the potential to influence offshore investment decisions. Of the survey responses in which foreign government factors had some influence, 48 per cent mentioned 'other' factors as being most important. Among these were foreign investment controls and performance requirements on foreign firms, which may restrict inward foreign investment or channel investment away from specific sectors.

The effects of foreign 'pull' factors

Where foreign 'pull' factors such as incentives and trade barriers provide an additional motivation to locate offshore, over and above the incentives provided by market demand factors or input cost considerations, they will tend to increase the volume of offshore investment in the first instance. The additional flows in turn will have their own impact on trade, investment, employment, production and ultimately on national income and wealth.

The policy question from Australia's perspective is whether the fact that the flows are encouraged by foreign 'pull' factors means that they would be less beneficial than other types of offshore investment or domestic alternatives. A less beneficial outcome could occur in one of two ways. The distortions could interact with the particular offshore investment to reduce the benefits to Australia. Alternatively, the distortions could affect the trading environment generally, reducing the potential benefits from trade and investment flows more broadly.

It is unlikely that there would be significant direct interactions between the foreign distortion and Australia's offshore investment that would reduce the benefits to Australia. Foreign tax incentives or tariff barriers create distortions by artificially encouraging resources into the protected or subsidised sectors, at the cost of finding alternative uses for the resources in the foreign country with higher social returns. Australian offshore investment may serve to exaggerate the resource flows into the protected or subsidised sectors, but the relevant opportunity cost for Australian investors is the return on alternative uses internationally, or in Australia. Unless there is a significant difference between private and social returns, the wider scope of the alternatives for Australian investors will tend to ensure that the cost of the distortion is borne primarily by owners of immobile factors of production in the foreign country. Thus, offshore investment could exacerbate the distortion, but the costs of doing so would tend not to be borne by Australian investors.

Nevertheless, the distortions created by incentives or trade barriers could have wider implications for the trading environment, and could indirectly hurt Australian interests. For example, incentives and trade barriers designed to encourage local production (even if it is not locally-owned) in the foreign country could tend to reduce its imports of the same goods and services from other countries, including Australia, thus harming the trade prospects of other Australian firms and artificially limiting Australia's overall gains from trade. Offshore investment to take advantage of investment incentives or to circumvent trade barriers may allow Australian investors to share in some of the rents created. However, a more liberal and less distorted trading environment is likely to be even more beneficial to Australia.

These considerations are illustrated by the following comments made by the Minerals Council of Australia:

> One of the minerals industry's major concerns in Asian markets is tariff escalation in the downstream minerals chain, unfairly biasing investment decisions for future metal smelting and other value-added processes against alternative locations, such as Australia, as well as reducing opportunities for Australia and other suppliers to compete [through exports] against existing domestic metal availability (Sub. 24, p. 24).

Trade distortions tend to reduce the volume of trade and lower the efficiency of the economy. Their removal is likely to increase trade volumes generally. The available evidence is that, in the absence of distortions, trade and offshore investment are complementary, and that many types of market demand-driven offshore investment follow from initial contacts through trade. A more liberal environment is therefore likely to be associated with higher stocks of offshore investment in total, as well as greater volumes of trade. Hence, it is appropriate for Australia to continue to support trade liberalisation and to seek a freer international investment climate in multilateral fora, even though this might be at the expense of some currently profitable avenues for Australian investments offshore.

The effects of foreign 'stop' factors

Many foreign governments adopt policies which reduce or prevent the flow of foreign investment, primarily through foreign investment controls and performance requirements which restrict inward foreign investment or channel it away from specific sectors.

Performance requirements may limit or prevent firms from capitalising on market-driven opportunities. The Council of Textile and Fashion Industries said that, for TCF industries, this:

> ... is largely attributable to the tendency of host countries for ADIA to specify that all, or a considerable proportion, of production must be exported ... in practice, such exports have tended to be restricted to re-exporting to the Australian market. In these instances, it is simply import replacement rather than higher export sales growth. Exports to third countries are not possible because of restrictions in these markets, most notably quotas, which prevent access from low cost developing country sources — the 'cost driven' location for ADIA and offshore production (Sub. 32, p. 2).

Where such distortions make it more costly or unprofitable for Australian firms to locate offshore, they are likely also to reduce Australia's welfare.

Offshore investment may also be affected by foreign government investment rules. Whether there are any benefits to Australia from these rules will depend in part on the obligations they may impose on local venture partners.

Australian firms face a range of information disadvantages when venturing into foreign markets, whether by exporting or by offshore investment. Licensing to a host country entrepreneur or investing with a host country venture partner are ways of gaining access to local knowledge to overcome the locational disadvantage. However, they create additional problems of ensuring that the local licensee or venture partner acts sufficiently in the interests of the Australian partner. It could be argued that some foreign government controls on foreign investment are designed to overcome information gaps, and may also impose discipline on local venture partners. In the longer term, however, a sound legal framework within which private contracts can be mutually agreed and enforced is likely to be a better way of ensuring appropriate corporate behaviour, while information can be provided without the need for investment regulations.

Australia has a direct interest in working to remove foreign 'stop' factors. The investment that occurs despite them is driven by profitability considerations and generates benefits for Australia. Removal of the 'stop' factors would reduce costs and improve profitability, increasing the opportunity for Australia to gain from offshore investment.

Domestic policy distortions

Australian government policies or other inefficiencies may affect the volume or direction of ADIA directly or indirectly. They can be understood in terms of 'push' and 'stop' factors. In practice, most domestic policy distortions push investment offshore, rather than prevent it from doing so. As exceptions, Australia still has high tariffs and other trade barriers in some sectors which encourage investment in local production. In addition, some of Australia's tax rules might appear to encourage investment in Australia rather than offshore.

The domestic distortions which potentially affect the impacts of ADIA are competition policy, tariffs and trade barriers, factor market regulation and environmental regulation. As noted in the previous chapter, domestic distortions were generally less influential than foreign government factors in influencing offshore location decisions. Nevertheless, they are more amenable to Australian government policy action. They are also of concern to industry because of their potential to reduce the benefits of offshore investment. The Council of Textile and Fashion Industries said:

> Our concern lies with distortions present in the Australian economy which have increased ADIA by encouraging the transfer offshore of internationally competitive Australian TCF investments. This 'distortion driven' ADIA has prevented Australian TCF companies from realising the most efficient and internationally competitive mix of offshore and domestic investment (Sub. 32, p. 1).

The effects of domestic 'push' factors

Domestic 'push' factors tend to expand the volume of offshore investment beyond that explained by commercial factors. They tend to have in common the characteristic that they tax (explicitly or implicitly) the returns to investing in Australia, either directly or by increasing the costs of doing business domestically. For example, although competition policy is designed to address one type of distortion (by preventing mergers that would substantially lessen competition), if applied too strictly it can create its own distortion, by preventing efficiency-enhancing domestic investments. It thus may penalise local production and encourage affected firms to make offshore investments with lower returns than otherwise. Inefficient regulations affecting labour markets, land usage or environmental quality can similarly raise the costs of doing business domestically, also encouraging affected firms to invest offshore at lower returns than otherwise.

Domestic policy distortions also have real and adverse effects on the Australian economy. The policy question is whether there is anything about ADIA that can make the domestic effects of the policy distortions worse, in the process reducing the benefits of offshore investment from what they otherwise would have been.

Offshore investment can set up such a negative interaction when it exacerbates the effect of a domestic distortion. 'Push' factors such as factor market distortions have the effect of reducing the resources devoted to the implicitly taxed activity. Offshore investment itself generally provides a vehicle for resources to flee the implicitly taxed activity. Therefore, offshore investment driven by 'push' factors will generally exacerbate the effect of the distortion, yielding a lower gain than it would in the absence of the distortion.[8]

The question then is whether policies to control the volume of offshore investment would do any better. This is unlikely, since a successful offsetting policy would need to ensure not merely that resources did not flee Australia, but that they did not flee the particular sectors affected by the distortions. It is difficult to see how an offshore investment policy could be designed to do this without also preventing genuinely market demand-driven investment. Since the evidence is that the bulk of offshore investment is market demand-driven, and that its benefits are sizeable, a preferable strategy would be to address directly the policy distortions which offshore investment may exacerbate. This is consistent with the view put by CRA to this inquiry:

> CRA is of the view that there is no need for Australian Governments to enact specific measures to encourage or discourage Australian mining companies from locating parts of their operations offshore. However, further successes in the microeconomic reform programme and a greater access to land within Australia will lead to greater attractiveness of Australia as a destination for new mining investment (Sub. 13, p. 23).

Chapter 6 discusses labour market inflexibilities, Chapter 8 discusses native title legislation and Chapter 9 discusses other domestic 'push' factors, including transport costs and competition policy issues, in this context.

The effects of domestic 'stop' factors

The prime 'stop' factor appears to be some high tariffs and other forms of domestic industry assistance, which may keep resources artificially in the protected sector in Australia, rather than being used offshore or in alternative domestic sectors. Another is tax policy, some aspects of which may encourage investment in Australia rather than offshore (although some aspects may have the opposite effect). A potential future 'stop' factor would be the introduction of environmental codes which unduly restricted the offshore operations of ADIA firms (see Chapter 7).

Offshore investment encouraged by the lowering of Australian tariffs does not exacerbate a distortion. Instead, it is a vehicle for eliminating it, by reducing the extent of resources devoted to an artificially protected domestic activity. Because there is no potential conflict between the benefits of offshore

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8 Wong (1995) gives a good summary of possible welfare costs of capital flows in the presence of policy distortions. The above discussion assumes that Australia is sufficiently small in world capital markets that artificially expanding or contracting the volume of its offshore investment would not induce changes in the global required return to capital.

investment and the benefits of reducing trade barriers, this domestic policy is not discussed further in this report.

In the case of taxation, the nature of the initial distortion is slightly less clear. Many types of taxation can create distortions, by artificially encouraging resources to move into or out of activities for which they would not otherwise be used. However, governments set tax revenue targets in order to achieve a range of social goals, principally to provide economic and social infrastructure and to affect the distribution of income. If the goals are accepted, the key issue for tax policy is not to eliminate its distorting effects, but to minimise the distortions associated with raising a given amount of revenue. Chapter 5 discusses the influence of Australia's system for taxing foreign-sourced income in more detail.

Summing up on domestic policy distortions

In some instances, notably when Australia seeks to reduce domestic and foreign trade barriers, to eliminate investment impediments and artificial inducements, and when domestic competition policy is used appropriately, there is no conflict between the direction of Australian policy and the benefits to Australia from offshore investment.

In other instances, domestic policy settings create distortions which ADIA tends to exacerbate, thereby reducing the benefits from that offshore investment. Some of these policy settings work to push too much investment offshore, while other policy settings may artificially restrict it. This suggests that there is no simple solution to be had by controlling the volume of offshore investment.

More often than not, when domestic policy distortions are damaging the domestic economy, an offshore investment response that exacerbates the problem is a symptom that something is wrong. The solution is to avoid 'shooting the messenger'. It is more efficient to address the domestic policy distortions directly, while letting investors decide the appropriate level of offshore investment that will maximise its benefits to Australia. That is the theme of remaining chapters of this report.

5 TAXATION OF INTERNATIONAL INCOME

5.1 Introduction

Decisions by firms in Australia to locate some operations offshore are seldom motivated solely by taxation considerations. Nonetheless, taxation can have a significant influence on offshore investment decisions. The Business Council of Australia said that:

> Taxation is the second most important government-related factor, after 'regulatory arrangements', in pushing investment offshore (Sub. 22, p. 1).

In circumstances where other factors are equal, tax becomes a more important determinant of location decisions. For instance, the Association of Mining and Exploration Companies (AMEC) said:

> ... given similar prospectivity in an offshore location, a higher taxation scheme in Australia and greater incentives to invest in an offshore location will certainly affect the mining companies' decision to locate offshore (Sub. 30, p. 7).

Once a decision is made to locate offshore, tax can have a significant influence on the choice of location. In this context, the OECD (1991) commented:

> ... the taxing of profits can and often does have an important impact on marginal investments and their financing, as well as on locational decisions both within a country and across frontiers (p. 12).

Some participants drew attention to specific elements of Australia's taxation regime which affect the competitiveness of Australian firms generally. For example, the Minerals Council of Australia requested that the Commission consider ways of addressing the vertical fiscal imbalance of the present tax arrangements and examine the tax treatment of so-called 'black holes' — expenditure items which are not currently deductible in Australia (for instance, pre-exploration costs, contributions to regional infrastructure and demolition costs) or the deductibility of which is uncertain (such as expenditure associated with native title processes). Similarly, the Council of Textile and Fashion Industries of Australia sought reform of the payroll tax for small business enterprises, while AMEC expressed concerns about the possible abolition of the Diesel Fuel Rebate Scheme, emphasising the inefficiency of taxes on business inputs.

The Commission acknowledges that these matters are important for competitiveness and that there are some major shortcomings in Australia's taxation structure. Indeed, some of these can create a bias against exports and hence, at the margin, can indirectly influence ADIA. (Some of these weaknesses, which are discussed in some detail in the Commission's recent *Stocktake* report (Productivity Commission 1996), are outlined in Box 5.1.)

Box 5.1: Weaknesses in Australia's taxation structure

The Commission examined Australia's taxation structure in its recent *Stocktake* report. It identified shortcomings from the perspective of both economic efficiency and equity. Specific problem areas identified include:

Commonwealth commodity taxes

- The narrow base, many exemptions and differential rates of the wholesale sales tax, excise taxes and customs duties
- The failure to exempt all inputs into production processes
- The regressive nature of the existing mix of indirect taxes

Personal and corporate income taxes

- Inconsistent treatment of different forms of savings
- High marginal rates reflecting excessive reliance on income taxes
- The lack of indexation of both the personal and the corporate income tax base
- The large gap between the company tax rate and the maximum personal rate

State and Territory taxes

- Excessive reliance on narrowly based taxes (eg stamp duties)
- Inefficiencies resulting from wide ranging exemptions to broader State/Territory taxes (eg land tax)

Compliance costs

- A perception of unduly complex administration and compliance procedures

Source: Productivity Commission 1996.

The Commission also recognises that, in principle, it would be preferable if the taxation treatment of international income was considered in conjunction with all taxes which impinge on investment decisions, as well as associated allowances (such as depreciation rates and research and development concessions) and Australian Taxation Office (ATO) practices and rulings (such as transfer pricing guidelines). However, such a review would raise complex and broad-ranging issues which have implications for all firms, not just firms with offshore investments. In an inquiry of this nature, it is not appropriate to undertake such a comprehensive assessment.

Consequently, in accordance with its terms of reference, the Commission has focused on those taxation measures which directly affect income earned from offshore investments by Australian firms. In doing so, it recognises that it is sometimes difficult to divorce consideration of these issues from other capital flows, such as portfolio investment and inward direct investment. However, in the Commission's view, focusing on specific measures affecting ADIA does not detract from its analysis and findings.

The issues discussed in this chapter nonetheless canvass some complex concepts. Accordingly, to facilitate analysis and understanding, the discussion has been simplified in order to illustrate more clearly the key relationships. This simplification necessarily masks some matters and abstracts from some practical issues. For instance, in illustrating the impact of different international tax regimes, the discussion focuses on initial, or first round, effects on firms and individuals. Similarly, it needs to be recognised that, in practice, distinctions between the various tax regimes and taxpayers (firms and individuals) are, in many instances, not clear-cut. For example, with increasing mobility of firms and individuals, even the distinction between resident and non-resident taxpayers is no longer straightforward. Simplified definitions of some technical terms used in this chapter are set out in Box 5.2.

The chapter commences by outlining some benchmarks commonly used for assessing the impact and efficiency of international tax systems. Section 5.3 summarises the major components of Australia's present arrangements for taxing international income. The appropriateness of these arrangements is assessed in Section 5.4.

5.2 Taxation efficiency benchmarks

From an economic perspective, a taxation system is *efficient* if it raises the revenue needed by government at least cost, minimising distortions to economic activity as well as compliance and administrative costs. *Simplicity* is required to enable the system to be easily understood and to help ensure that administrative and compliance costs are minimised. And an *equitable* system is desirable to ensure that the burden of taxation is spread 'fairly' over all members of the community. This requires judgements about the appropriate treatment of taxpayers whose economic circumstances differ.

Box 5.2: Some taxation terms used in this chapter

Active income	Income from ‘genuine’ business activities – for instance, the income earned from manufacturing operations (as distinct from portfolio investment income).
Capital export neutrality	A system of taxation in which the income from capital invested abroad is taxed at the same rate in total (foreign plus domestic tax) as that earned domestically.
Capital import neutrality	A system of taxation whereby the income from foreign inward investment is taxed at the same rate as that from domestically-owned and invested capital.
Double taxation agreement	A treaty between two countries with the aim of reducing the taxation of the same type of income by two or more governments.
Franked dividends	Dividends paid out of corporate income on which Australian company tax has been paid and which therefore carry franking credits.
Imputation	An arrangement whereby the recipients of dividend income are entitled to a credit for company tax paid against their personal income tax liability.
Listed country	A country designated as having a tax system and tax rates comparable to those in Australia.
National neutrality	A resident-based system of taxing foreign-sourced income under which Australian tax is imposed after allowing a deduction for any foreign tax paid.
Passive income	Income which is not derived from genuine business activities – for instance, dividends and interest income.
Unlisted country	A country not designated as having a tax system and tax rates comparable to those in Australia.
Withholding tax	A tax on income which is deducted before remittances are made to the beneficial owner.

Although those criteria are well established, there is considerable debate about the optimal structure of a regime for taxing international income. Indeed, Slemrod (1994) stated:

> How to design the minimal distorting [international] tax system, subject to the other goals of the tax system such as equity and simplicity, has preoccupied public

> finance economists for more than half a century. Unfortunately, no consensus has arisen on simple rules for achieving this goal (p. 9).

To some extent, this situation reflects the need to make trade-offs between competing objectives. For instance, it is inevitable that some trade-off has to be made between keeping the tax regime as simple as possible while, at the same time, limiting the scope for tax avoidance. There are also varying opinions about whether it is most appropriate for an individual country to seek (in the first instance) to maximise national welfare or global welfare.

While there is no agreement about the optimal configuration for a country's international tax regime, there are, theoretically, two 'polar' options for taxing international income. These involve taxing on the basis of the so-called 'pure residence' principle and taxation based on the 'pure source' principle. The former requires that a jurisdiction tax only its residents, on both their domestic and foreign-sourced income. The latter requires that only income generated within a given jurisdiction, whether by domestically-owned or by foreign-owned capital, be taxed.

Very few, if any, countries have implemented such 'pure' taxation systems. In practice, most countries have developed international income taxation arrangements which combine elements of both systems. Although there is a great deal of variation, the approaches employed can be broadly categorised as seeking to achieve:

- national neutrality (NN);
- capital export neutrality (CEN); or
- capital import neutrality (CIN).

The approaches are 'partial' in the sense that they do not deal with the taxation of *both* capital inflows and capital outflows. Simplified numerical examples illustrating the different approaches in relation to $100 of foreign income are shown in Box 5.3. The examples show that different ways of taxing international income result in different private returns, even though social returns are equal.

Box 5.3: Comparison of tax treatment of domestic and foreign-sourced income under NN[a], CEN[a] and CIN[b]

	Domestic income	*National neutrality*	*Capital export neutrality*	*Capital import neutrality*
Foreign-sourced income	n/a	100.00	100.00	100.00

Foreign tax (assume 20%)	n/a	20.00	20.00	20.00
Repatriated to home country	n/a	80.00	80.00	80.00
Assessable in home country	100.00	80.00	100.00	n/a
Domestic tax (36%)	36.00	28.80	36.00	0.00
Less credit for foreign tax paid	n/a	n/a	20.00	n/a
Domestic tax payable	36.00	28.80	16.00	n/a
Total tax (foreign and domestic)	36.00	48.80	36.00	20.00
Available for distribution	64.00	51.20	64.00	80.00

a Adopted in the home country.
b Adopted in the host country and supported by the home country through an exemption from domestic tax.

Notes:

1. The examples are stylized applications of the theory and assume corporate tax only. Under Australia's imputation system, resident shareholders would be further taxed on dividends paid out of the foreign-sourced income but be granted credits for any Australia company tax paid. Assuming a 47 per cent personal income tax rate, shareholder net income would be: $53, $42, $42 and $42, respectively (columns from left to right).
2. Under the pure residence principle, adopted globally, the taxation of foreign-sourced income would be equivalent to that applying to domestic income. Adopted unilaterally in the home country, it would be equivalent to that under NN. The taxation of foreign-sourced income under the pure source principle would be equivalent to that under CIN.

Each of the taxation principles mentioned above is discussed below. However, prior to this discussion, it is important to note the distinction between the interests (and welfare) of private investors (or firms) and those of the nation as a whole.

From a *firm's* perspective, taxes are similar to costs and must be taken into account when assessing investment returns. Thus, at the firm level, profits will be maximised when the post-tax marginal returns from all investments are equal.

From a *national* perspective, the situation is somewhat different. While there are costs associated with the collection of taxation revenue, taxes paid in Australia represent income transfers within the community and need to be included when assessing the returns to the nation from private investments. Hence, returns to the Australian community as a whole will be maximised when the marginal returns from all investments are equal *before* the payment of Australian tax.

The pure residence principle

Under the pure residence principle of taxation, each country taxes only its own residents. They are taxed on their global income — domestic income plus foreign-sourced income. Income accrued abroad (but not repatriated) is taxed in the same way as income accrued at home (but not distributed to shareholders). But income earned by non-residents (whether accrued or repatriated) is not taxed in the host country.

If such a system were implemented world-wide, capital, in principle, should flow across borders until the *pre-tax* rate of return to a firm's investment is the same in each country. As investors in any particular country would face the same overall rate of tax on domestic and on foreign-sourced income, the taxation arrangements would have no effect on decisions about the location of new investments. Thus, implemented world-wide, the pure residence principle of taxation has the potential to result in an efficient allocation of each country's productive resources, both nationally and globally.

There can be significant revenue implications, however, for a single country wishing to implement a system based on the pure residence principle. More specifically, it would forgo tax revenue from the earnings of multinational firms resident in countries which provide credits for foreign tax paid. Taxing these entities would have no impact on activity levels because it would not change the *total* tax paid by them — it would affect only the distribution of the revenue between governments. The implementing country would most likely also want to take into account the fact that its foreign-sourced income is almost certain to have been taxed first in the host country. Two variants of pure residence taxation which recognise this latter problem are, first, a system based on national neutrality and, second, a regime incorporating capital export neutrality principles.

National neutrality

National neutrality (NN) is a residence-based system of taxing foreign-sourced income which seeks to maximize national income in the presence of foreign taxes on foreign-sourced income. To this end, it takes foreign tax as given and imposes a uniform level of domestic tax on the income of all residents, irrespective of whether the income is earned domestically or overseas. Any foreign tax paid on overseas income is treated as just another expense, with domestic tax imposed on all foreign-sourced income — net of foreign tax — at the prevailing domestic rate (see Box 5.3).

Subjecting foreign-sourced income to double taxation discourages offshore investment relative to domestic investment, compared to a system which gives credits for foreign taxes paid. Nonetheless, in theory, an NN-based tax system will result in domestic capital being employed most efficiently from the implementing country's perspective, because local investors will allocate their investments so that their marginal returns after tax (local plus foreign tax) on both local and overseas investments are equal. In these circumstances, the gross marginal return to the home country (private returns plus home country tax) from domestic and overseas investments are the same. As a result, foreign investments generally would be undertaken only if they produce as high a return to the home country as would alternative domestic investments.

A tax system based on NN principles may have the potential to raise higher tax revenue than systems based on CEN or CIN. However, there are some potential costs associated with the implementation of an NN system. In particular, the incentive it provides for firms to invest domestically rather than offshore would tend to drive down the rate of return achievable domestically. In principle, this would discourage foreign inward investment.

The double taxation of foreign-sourced income and the resulting constraints on international capital movements would reduce *global* income. It would also conflict with the OECD Model Double Taxation Convention on Income and on Capital. In this context, Slemrod (1994) commented:

> ... the decline in income elsewhere will exceed the gain in domestic national income, so from a global perspective these policies are wasteful (p. 8).

Double taxation which arises as a result of a country adopting a regime based on NN principles could be viewed also as a 'beggar thy neighbour' type of policy, in the sense that it restricts the movement of domestic capital to other countries. For example, KPMG said:

> National neutrality is a nationalistic approach, which favours short term domestic gain over longer term gains which Australia could achieve through the enhancement of global wealth. It is, in the realm of taxation, akin to protectionism in the realm of trade and is contrary to the broad philosophy of APEC (Sub. 52, p. 3).

Thus, NN could be perceived as an initiative aimed at improving the income of the home country at the expense of other countries. This could invite retaliation and erode the expected gain to a country from moving to an NN-based system. In this context, Frisch (1990) stated:

> It ignores the fact that foreign governments would be likely to react ... and would change their own tax policies toward international investment. The result could easily be that all countries ... would experience a loss in economic welfare (p. 583).

The likelihood of retaliation — and the erosion of gains — are related to the size of the country. For a relatively large economy, the problem could be significant.

Capital export neutrality

A taxation system incorporating CEN principles results in the same total tax (aggregate domestic plus foreign tax) on all residents' income, irrespective of whether it is earned domestically or overseas.[1] This is achieved by the home country taxing investors' total global income at the domestic rate, but granting a credit for tax paid to overseas governments (see Box 5.3).

Taxation based on CEN would create no locational bias from the investors' perspective. It would mean that resident investors' decisions between investing domestically or overseas would not be influenced by tax considerations. (Technically, the marginal effective tax rate would be the same for investments anywhere in the world.) Thus, CEN — if universally adopted — would not distort locational decisions and would be compatible with the world-wide efficient allocation of capital.

A CEN-based regime would encourage greater uniformity in corporate tax rates between countries because, if universally adopted, capital importing countries would have an incentive to move their tax rates closer to those in countries from which they import capital, in order to increase their share of the tax collected from multinational corporations' income. Thus, CEN would provide an incentive for greater harmony in global corporate tax rates, but with a tendency to higher rates.

The pure source principle

Under the 'pure source' principle, each country taxes — at the same rate — all income generated within its borders, whether generated by domestically-owned or by foreign-owned capital, and does not tax foreign-sourced income earned by its residents. Taxing income according to source forms the basis for taxation regimes which seek to achieve capital import neutrality (CIN).

Capital import neutrality

CIN focuses predominantly on the question of how the income of foreign residents should be taxed. As the term implies, CIN holds when the income from domestically-owned and invested capital is taxed at the same rate as that

1 Like NN, CEN does not address the taxing of income from imported capital.

from foreign inward investment. This is not a central issue in this inquiry. However, as noted above, the method adopted for taxing foreign-sourced income may have implications for the return achievable on capital invested domestically, and consequently on capital inflows and national income. For instance, if Australia wished to treat the foreign income of local investors according to NN principles, while at the same time not discouraging foreign inward investment, taxing the income from foreign inward investment on the basis of CIN might not be appropriate. In these circumstances, it might be necessary to tax income earned domestically by non-residents at lower rates than income earned by residents. Indeed, a recent theoretical development in international taxation suggests that, in broad terms, the higher are taxes on exported capital, the lower they should be on imported capital, and vice versa. This new theory — known as the 'see-saw' principle —is still the subject of some debate among international taxation experts.[2]

If tax rates were uniform for all countries, CIN and CEN could be achieved simultaneously. However, in practice, large differences exist.

The widespread adoption of CIN — like CEN — would encourage more uniform global tax rates (because countries would not wish to deter investment unnecessarily through relatively high tax rates). However, unlike CEN, CIN would create pressures for a general lowering of tax rates.

Another difference between CIN and CEN highlighted by the OECD is the trade-off between the allocation of world savings and the allocation of global investment. It has been noted by the OECD (1991) that CEN would promote an efficient allocation of investment, but an efficient allocation of savings is more likely to be achieved under CIN:

> When capital income tax rates differ across countries, achievement of CEN implies different net returns to saving in different countries and will therefore tend to distort the international allocation of savings. At the same time ... CEN would tend to equate the 'cost of capital' (the required pre-tax rate of return) across countries. By contrast, achievement of CIN would guarantee roughly identical after-tax rates of return to savings for savers in different countries, but would distort the pattern of international investment by causing the cost of capital to deviate from one country to another (p. 40).

To the extent that private savings are relatively inelastic with respect to the net rate of return, CEN is generally seen as preferable.

Participants at the Tax Round-table (see Appendix A) generally confirmed that there is no consensus about the optimal configuration of an individual country's international tax regime. In principle, a case can be made for supporting CEN-

[2] See, for instance, Slemrod, Hansen and Procter 1994.

based systems in order to maximise global welfare. On the other hand, if the prospect of retaliation were not a significant problem, it could be in the interest of individual countries to employ a system incorporating NN principles.

5.3 Australia's international taxation system

Australia's international taxation system is governed by the *Income Tax Assessment Act 1936*. Since its inception, the Act has been subject to numerous extensions and modifications.

In most instances, the principles enshrined in the Act are relatively straightforward. For example, underlying the taxation issues of most relevance to this inquiry are two fairly simple principles:

- Australian residents should be taxed on world-wide income; and
- non-residents should be taxed on Australian-sourced income.

However, the implementation of these principles involves quite complex legislation. In part, the complexity arises because, unless some account is taken of the taxation measures employed by other countries, income from foreign direct investments would be taxed twice. This would impede international capital movements and reduce global economic efficiency.

Differences in tax rates and tax bases between countries create the potential for the avoidance of Australian tax payable on foreign income and add to the complexity of the legislation. With improvements in communication technologies and the easing of restrictions on capital movements, the scope for exploiting these differences has increased over time. In response, there has been a sequence of amendments to the legislation to help preserve the tax base. For instance, before the Act was amended to incorporate provisions dealing with the activities of controlled foreign companies and foreign investment funds (see later discussion), Australian resident individuals and Australian companies were not taxed on the foreign income of their overseas subsidiaries until it was repatriated to Australia. This provided scope for the deferral of Australian tax on such income, sometimes indefinitely by sheltering it in tax havens.

During the 1980s, Australia's taxation arrangements — including those governing the taxation of international income — underwent considerable change to make the system more efficient and equitable. The changes to the international taxation arrangements generally were regarded favourably by participants, although some suggested that there was still scope for improvement.

The present arrangements are complex and allow for a variety of different circumstances. In order to simplify the discussion, the following description focuses only on the most prominent features of the present international taxation arrangements. It does not attempt to identify special provisions which exist for certain activities (such as offshore banking) or those which cater for particular circumstances (for instance, where income does not exceed a certain minimum level). Modifications to the present arrangements suggested by participants are discussed in Section 5.4.

The taxation of income from foreign direct investment

The income from foreign direct investment is taxed *in Australia* in two stages. The income is first subject to taxation when the Australian resident company is assessed on the repatriated (and in some cases also the accrued) income of its foreign subsidiary. The second stage is when income is distributed to shareholders.

Taxing of corporate income

The legislation introduced for assessing foreign-sourced income in Australia in the late 1980s and early 1990s recognises two broad categories of foreign income. These are:

- income from activities ‘controlled’ by Australian residents; and
- income from activities over which Australian residents have no control.

The assessment procedures employed for the latter category are known as the ‘foreign investment funds’ measures. Broadly speaking, they govern the taxation of income from international *portfolio* investment. Consequently, they are not the focus of this inquiry. However, the first group of measures is directly relevant to this inquiry. These measures, which are known as the ‘controlled foreign company’ (CFC) measures, are concerned with the taxation of income derived from foreign *direct* investment by Australian residents.

CFC measures

Before the introduction of the CFC measures in 1990–91, income from corporations not resident in Australia, but owned and controlled by Australian residents, was taxed in Australia only when remitted to Australia. As noted above, this provided an incentive for foreign-sourced income to be ‘sheltered’ in low tax countries, or to be reinvested overseas:

> ... creating more income and wealth for the beneficial owners of the foreign entity without their paying much or any Australian or other tax on the income (Keating 1988, p. 4).

The CFC measures are complex and provide for a wide variety of circumstances. However, as a broad generalisation, they result in the rate of Australian tax levied on foreign-sourced income depending on, first, whether or not the income is sourced from a 'listed' country and, second, whether the income is classified as 'active' or 'passive'. For taxation purposes:

- *listed countries* are those countries designated by the Government as having a taxation system and rates comparable to those of Australia;[3]
- *unlisted countries* comprise all other countries;
- *active income* is defined as income from 'genuine' business activities (which broadly corresponds to value-adding activities undertaken in foreign countries such as manufacturing, mining and service sector activities); and
- *passive income* is defined as income derived from other sources such as dividends, interest, rental income and income from copyrights, patents, designs and trademarks.

Around 60 countries were listed when the CFC regime was introduced in 1990. They account for more than 90 per cent of total ADIA. Hong Kong (corporate tax rate 17.5 per cent) is the only unlisted country of significance, accounting for almost 3 per cent of total ADIA.

Under Australia's CFC regime, 'active' income from listed countries is exempt from Australian corporate tax.[4] This exemption is provided because deferral is not a problem if income generated abroad is subject to a level of tax comparable to that in Australia. Under such circumstances:

> The decision to invest in one country or the other will then be made on sound commercial grounds, not tax-induced biases (Keating 1988, p. 2).

There are also administrative advantages. For example, the administrative and compliance costs associated with providing a credit for foreign tax in a country

3 In broad terms, this means that a country must have: income-based taxation; a definition of income broadly the same as that employed in Australia; no special tax incentives which encourage international profit shifting; and a company tax rate of at least 25 per cent.

4 Some of these, however, have their listing qualified by 'eligible concession income'. This comprises income not taxed at all in the host country (such as capital gains in some countries) or income taxed at reduced rates in the host country. This income is subject to Australian tax.

with similar tax rates are likely to be high relative to the tax which would be collected after providing the credit.

‘Active’ income sourced from unlisted countries is subject to Australian tax, but a credit is provided for foreign tax paid. However, the income is not liable for Australian tax until it is repatriated. To this extent, the tax treatment of ‘active’ income earned in unlisted countries is more favourable than that afforded similar income earned in Australia (which is subject to tax as it accrues annually).

Underlying the exemption from accruals taxation of ‘active’ income earned overseas was the belief that deferring repatriation of such income is not usually motivated by tax avoidance. It was also considered that accruals taxation could have adverse effects on the competitiveness of Australian-owned businesses abroad. Another argument in favour of the exemption was said to be the difficulty many taxpayers would have in recomputing, according to Australian tax law, their ‘active’ business income (Keating 1989, p. 45).

Following the introduction of the CFC measures, ‘passive’ income earned in unlisted countries that is accrued, but not repatriated, became assessable for Australian tax. This was intended to reduce the incentive for deferring the repatriation of foreign-sourced ‘passive’ income to Australia.

The treatment of ‘passive’ income in listed countries varies. However, in general, ‘passive’ income sourced from listed countries which have tax regimes most closely comparable with that in Australia is treated in the same manner as ‘active’ income from these countries — it is exempt from Australian tax. Certain ‘passive’ income from other listed countries is treated the same as ‘passive’ income from unlisted countries — it is subject to Australian tax on an accruals basis (and is exempt from further Australian tax when it is repatriated).

Income earned and accrued abroad, but not repatriated, which is taxable in Australia as it is earned is known as ‘attributed’ income. In 1993–94, ‘attributed’ foreign income represented around 4 per cent of total foreign income derived by individual taxpayers.

Some participants expressed concern that, despite repeated industry representations for new inclusions, the number of listed countries has not changed since its inception. For instance, BHP said that countries like Vietnam and Argentina, which they consider to have tax regimes comparable to Australia’s, remain unlisted and that:

> This has been a particular problem ... as Treasury and the Australian Taxation Office have been unable to deal with changes in sovereignty and country tax regimes since that time (Sub. 38, p. 8).

Taxing shareholders' income

Until 1987, Australia had what is commonly termed a 'classical' system of taxation. Under this system, companies were taxed on their profits as separate legal entities and, when those profits were passed on to individual shareholders in the form of dividends, they were taxed again as personal income. Thus, under a classical system, the same income is taxed twice by the one government.

To reduce the incidence of double taxation, an 'imputation' system was introduced in 1987. Under this arrangement, Australian resident shareholders can offset company tax paid in Australia against their Australian personal tax liability.

Double taxation is not fully avoided, however, because only Australian (and not foreign) company tax paid is available for the granting of imputation credits. In the extreme case, Australian resident shareholders receiving dividends paid entirely from the earnings of a foreign subsidiary of an Australian company would receive no imputation credits and would be fully taxed in Australia at their personal marginal tax rates. Hence, Australian resident shareholders are taxed only once on Australian-sourced income, but are taxed twice on foreign-sourced income.[5]

Non-resident shareholders, like resident shareholders, receive a credit for Australian company tax paid. However, their governments generally do not recognise Australian imputation credits. Hence, their dividend income is frequently subject to corporate tax in Australia and personal income tax in their country of residence.

Withholding tax

Non-resident shareholders liable for tax on their dividend income generally have this tax deducted, or 'withheld', before the dividends are remitted; hence the term 'withholding tax'.[6] Prior to 1987, withholding tax was payable on all dividends remitted to non-resident shareholders. Following the introduction of imputation, the arrangements changed:

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[5] If the pre-tax return in listed and unlisted countries is equal, shareholders will receive a higher return if the foreign sourced income out of which their dividends are paid was generated in unlisted countries. This is because the additional Australian company tax paid will generate franking credits for shareholders.

[6] Dividend withholding tax is a 'final' tax. While this means that non-resident shareholders are not liable for any further Australian tax, they generally will be further taxed by their own government, but in some cases with a credit for Australian withholding tax paid.

- 'fully franked' dividends paid to non-residents became exempt from withholding tax. That means that dividends paid out of corporate income which has been subject to Australian corporate tax are now exempt from withholding tax; and
- dividends paid to non-residents solely out of foreign-sourced income, or out of Australian-sourced income on which no tax is payable, remained subject to withholding tax.

Since 1 July 1994, the incidence of withholding tax has been reduced for multinational companies in Australia which receive dividend income from foreign companies in which they own at least 10 per cent of the equity. Under the changed provisions, qualifying dividends can now be transferred (with some restrictions) to overseas parents without incurring dividend withholding tax.

Dividend withholding tax collected from non-residents in 1994–95 amounted to $110 million, just under 65 per cent of the $171.8 million collected in 1986–87, the last full tax year before imputation was introduced.

Where Australia has a double taxation agreement (see later discussion) with the country of residence of the corporate shareholder,[7] withholding tax is generally imposed at a flat rate of 15 per cent. Under these agreements, withholding tax is a reciprocal tax. Consequently, dividends remitted to Australian residents from treaty countries are also usually subject to withholding tax of 15 per cent (although a country can unilaterally opt for a lower rate). The dividend withholding tax applying to residents of other countries is 30 per cent. While Australian residents receiving dividends directly from abroad (from any country), and companies receiving dividends from their subsidiaries in unlisted countries, receive a credit against their Australian tax liability, companies investing in listed countries do not receive a credit (because the income from listed countries is exempt from further company tax in Australia).

Under the most recently concluded double taxation agreements — with the Czech Republic, Romania and Russia — and the revised Australia-Germany Double Tax Agreement, dividends repatriated from those countries to Australian corporate shareholders attract a 5 per cent withholding tax rate. All other dividends are subject to withholding tax at the 15 per cent rate. For instance, unfranked dividends paid by Australian companies to corporate shareholders in the Czech Republic attract the 15 per cent rate.

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7 Australia has concluded double taxation agreements with more than 35 countries.

5.4 Is the system appropriate?

As discussed above, Australia’s system for taxing international income at the corporate level differs from that for taxing international income at the shareholder level.

At the *corporate* level, the Australian taxation regime provides an exemption from Australian company tax for income earned in listed countries, and a credit and ‘top-up’ to the level of the Australian corporate tax rate for income generated in unlisted countries. This implies that foreign-sourced *corporate* income is taxed on the basis of CEN. However, although Australia nominally only lists countries with comparable tax regimes and tax rates, corporate tax rates currently applying in listed countries vary considerably (see Table 5.1). Many are substantially different from Australia’s rate of 36 per cent. (For example, the rates in Singapore and Sweden are 27 per cent and 28 per cent, respectively.) To the extent that corporate tax rates differ between Australia and the listed countries, the present arrangements depart from CEN principles.

The Australian system for taxing foreign-sourced corporate income also differs from CEN to the extent that, first, it exempts some foreign-earned income (active income) from Australian tax until such time as it is repatriated and, second, it precludes the payment of rebates for foreign tax paid in excess of that which would have been payable had the income been generated in Australia.

Table 5.1: Selected countries' statutory corporate tax rates

Country	*Statutory corporate tax rate*
Listed countries	
Canada	Federal tax 28%, plus provincial tax 6-17%
China	30% plus local surtax 3% (the latter may be waived)
France*	33.33%
Germany*	Resident companies 30% on distributed profits, 45% on undistributed profits; non-resident companies 42%; a surcharge of 7.5% applies to all.
India	Resident companies 40% plus surtax of 15% on income tax if taxable income exceeds Rs75 000; non-resident companies 55%
Indonesia	Progressive from 10-30%
Italy	National tax 36% plus local tax 16.2%
Japan	Enterprise tax progressive 6.3-12.6%, plus corporation tax 28-37.5%, plus inhabitants tax 5-20.7% of corporation tax, plus local government tax of between ¥70 000 and ¥4 400 000
Korea	18-32% depending on taxable income, plus a resident tax surcharge
Malaysia*	30%
New Zealand	33%
Singapore*	27%
Sweden	28%
United Kingdom	33% (companies with tax adjusted profits below certain limits 25%)
United States	Federal tax, progressive 15-35%, state taxes also apply in most cases, ranging between 1% and 12%.
Unlisted countries	
Argentina	30%
Chile	35% (42% for foreign investors who enter into a foreign investment contract for a period of 10 years)
Hong Kong	16.5%
Mexico	34%
South Africa	35%
Vietnam	Standard rate 25%, but preferential rates may apply (20%, 15% or 10%)

* Although a 'listed' country, certain categories of income (for instance, capital gains which are not subject to tax) are taxed in Australia as though sourced from an unlisted country.

Sources: Price Waterhouse 1995, various Embassies.

In summary, the combined effect of the CFC measures and Australia's double taxation agreements results in considerable differences in the treatment of foreign-sourced corporate income, depending on its country of source. Thus, at the *corporate* level, the taxation system is not neutral with regard to location decisions. In some cases it favours a foreign location over Australia, in other cases the reverse is true. It also favours some foreign locations over others.

The situation is different with respect to the beneficial owners of Australian multinational corporations. At the *shareholder* level, dividends are taxed at personal income tax rates, but with only a credit allowed for any Australian corporate tax previously paid. As no credit is permitted for tax paid to foreign governments, at the shareholder level the present arrangements accord broadly with the principles of NN.[8]

The Australian systems for taxing corporate income and dividend income do not, of course, operate in isolation. Thus, even if the taxation arrangements applying to corporate income did not inject any locational bias into new investment decisions, firms' decisions about the location of new investments are almost certainly influenced by the measures employed to tax shareholders' dividend income.

To the extent that firms' investment decisions are ultimately driven by the wishes of shareholders, the taxation of the foreign-sourced income of Australian firms reflects NN principles. However, in practice, the broad range of tax policy objectives relating to government revenue needs and efficiency and equity goals, as well as treaty obligations and certain practical considerations, result in the present arrangements deviating somewhat from 'pure' NN principles.[9]

The Commission considers that, in broad terms, Australia's system for taxing foreign-sourced income encourages domestic investors to allocate their capital so as to maximise returns to the Australian community.

In this inquiry, some participants were quite supportive of the present arrangements for taxing foreign-sourced income. For instance, Pioneer said:

> The fact that the [CFC] regime exempts from Australian tax dividends paid from 'listed' countries provides a significant benefit. The active income test and the exclusion from attribution of active business income in relation to 'unlisted' countries is also of benefit (Sub. 4, p. 11).

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8 In practice, imputation does not fully transform the system to a regime consistent with NN principles because not all profits are paid out as dividends and shares are not sold on an annual basis.

9 For example, as some profits are not distributed and only a fraction of shares are sold each year, there is some variation from NN principles.

However, even those supporting the CFC regime questioned certain aspects of the system and its administration. The more prominent of these issues are discussed separately below.

The 'need' for a competitive taxation system

It is often argued that Australia needs to have an 'internationally competitive' taxation system. Such views are espoused more often in the context of attracting inward foreign investment. However, it is also relevant for this inquiry in the sense that, in many international markets, overseas subsidiaries of Australian companies have to compete with local companies that benefit from lower corporate tax rates.

Australian companies are most disadvantaged when competing in unlisted countries. In these markets, resident companies frequently face low corporate taxes, but subsidiaries of Australian companies generally have their tax topped up to the level of Australian tax.

In the 1995 Commonwealth Budget, the Australian corporate tax was increased from 33 per cent to 36 per cent. Australia's corporate rate is now higher than that of many listed countries — such as China, France, Indonesia, Korea, Malaysia, New Zealand, Singapore, Sweden, the United Kingdom and the United States. Australia still compares favourably, though, with a range of other countries, including Germany, some Canadian provinces,[10] India,[11] Italy, Japan and South Africa.

Simple comparisons of corporate tax rates provide little or no guide to the overall effect of tax on profitability and firms' investment decisions. As a minimum, account also needs to be taken of the impact of general taxation conventions, other taxes, tax incentives and services provided by governments.

General tax conventions

Companies' tax liabilities are affected significantly by the tax conventions adopted in relation to such matters as depreciation, stock valuation, R&D expenditure and the carry-forward of losses. For example, Australian firms appear disadvantaged because the prescribed rates at which assets can be depreciated broadly reflect their expected economic lives, whereas some countries allow more rapid depreciation. For instance, Robert Bosch said:

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10 In Canada, in addition to Federal tax of 28 per cent, there are provincial taxes on corporate income varying between 6 and 17 per cent.

11 In India, non-resident companies are subject to corporate tax of 65 per cent and resident companies face a 45-50 per cent rate.

> ... a German holding company may depreciate permanent losses when they are identified. Australian companies may only obtain deductions after losses have been realised (Sub. 12, p. 3).

On the other hand, Australia's 150 per cent deduction for R&D expenditure is more generous than those of most other countries.

Other taxes

All other government taxes and charges which affect corporate profitability also need to be considered. These include tariffs, payroll taxes, turnover taxes, excise taxes and stamp duties.

Tax incentives

Another matter to be taken into account when comparing tax rates is the availability of special taxation-based incentives, particularly in some Asian countries and the newly industrialising countries in Eastern Europe. Such incentives include:

- general income tax rate reductions, either for a set period or indefinitely;
- tax holidays, usually for a period of between three and seven years, but sometimes for as many as fifteen years;
- differential (concessional) taxation applying to reinvested profits;
- reductions and exemptions provided for indirect taxes, border taxes, turnover taxes, payroll taxes etc;
- investment allowances which provide tax relief based on the value of expenditure on qualifying investment; and
- special purpose incentives — for instance, for regional development, employment creation, technology transfer, export promotion and free trade zones.

Some specific examples of these incentives are provided in Box 5.4.

Although some tax incentives are provided in Australia by State and local governments, incentives provided by the Commonwealth Government have been limited. Examples include accelerated depreciation allowances, development allowances, concessional tax treatment of investment companies and the 150 per cent tax concession for research and development. However, these incentives have not generally favoured one industry over another, or foreign investors over domestic investors. One recent exception was the $15 million wholesale sales tax concession offered to Cathay Pacific to move its aircraft flight simulator centre to Australia.

Box 5.4: Examples of special tax incentives

Indonesia offers ten-year tax holidays in selected sectors for newly establishing companies that are partly or wholly foreign owned. The tax exemption applies both to corporate income tax as well as tax on dividends paid to foreign shareholders.

Malaysia offers five-year tax holidays, and exemptions from import duties for machinery and raw materials for approved projects. Investments entitled to the special investment allowance can claim tax deductions of an additional 60 per cent of the value of machinery. Malaysia has several export promotion zones.

Singapore offers tax holidays of five to ten years. Investments entitled to the special investment allowance are able to deduct from taxable income an additional 50 per cent of the value of machinery. It has several free trade zones.

Taiwan permits companies in specially designated industries to base plant depreciation on half the statutory life of the assets.

Thailand exempts certain promoted enterprises from company tax for three to eight years. Exemptions from import duties for machinery and selected raw materials are also available. It has two export promotion zones.

Vietnam offers a two-year tax holiday plus another two years with tax payable at 50 per cent of the nominal rate. It also offers accelerated depreciation and investment allowances. A Vietnamese company with foreign invested capital is exempt from import duties on machinery and equipment, raw materials and spare parts. Vietnam has two export promotion zones and others planned.

Sources: EPAC 1995c; Nguyen and Robertson 1995; OECD 1995b; communication from the Indonesian Embassy.

Government-provided services

Account also needs to be taken of government services financed by tax revenue. For example, it is possible that low tax rates merely compensate for weaknesses in infrastructure and services, such as poor roads and high cost or unreliable electricity supplies. The cost of such services is also relevant — in particular, whether they are provided on a user-pays basis or are funded (wholly or in part) from taxation revenue.

Effective tax rates

EPAC (1995c) examined the overall impact of taxes on income earned from the corporate investment of capital funds in a range of countries. It found that Australia's average effective rate of tax for investment from selected OECD countries and certain Asian countries was 21.4 per cent. This compared favourably with investment into some major OECD economies such as France (23.2 per cent), Japan (30.2 per cent), the United Kingdom (22.3 per cent) and the United States (28.6 per cent), and with some Asian nations such as Indonesia (28.1 per cent), Korea (34.6 per cent), Thailand (27.1 per cent) and Taiwan (32.7 per cent). Effective tax rates were estimated to be lower in four of the countries covered by the study: Germany (14.2 per cent); the Netherlands (17.2 per cent); Malaysia (20.2 per cent); and Singapore (14.8 per cent).

Largely because of the study's limited coverage, care must be taken in interpreting these estimates. For example, the study did not take into account taxes on intermediate business inputs (such as wholesale sales tax and petroleum excise) or social security contributions levied separately from taxation in some of the countries studied.

Should Australia compete on corporate tax?

A number of participants said it was important for Australia to provide a competitive tax environment. For instance, the MTIA said:

> Without exception, companies which assisted MTIA in the preparation of this submission stressed the importance to Australia's international competitiveness of a competitive tax regime (Sub. 9, p. 27).

The Business Council of Australia contended:

> Taxation is an important element in the mix that goes to determine a country's ability to be internationally competitive (Sub. 35, p. 2).

Relatively high Australian tax rates have a number of effects on investment. In general, a relatively high tax rate would discourage investment by Australians in Australia, as well as discourage inward foreign investment. In addition, the incentive to devote resources to finding ways to avoid and evade tax would be increased. A relatively high level of tax would also discourage Australian companies with offshore investments in unlisted countries from repatriating profits. The significance of this latter effect would depend upon the responsiveness of capital to variations in tax rates.

Taxation concessions and incentives

Taxation incentives offered by some nations can accentuate differences in corporate tax rates. However, the evidence on their effectiveness is ambiguous. For instance, 14 per cent of respondents to the Commission's Survey of Offshore Investment ranked tax incentives as the most important offshore government factor. Others saw tax incentives as influencing location only *after* a decision to locate offshore is made. For instance, AEEMA said:

> These incentives may not alone induce companies to establish operations offshore but could be expected to enhance the financial position of any such proposal. In some cases the 'value' of incentives offered could influence the location of the operations either between competing countries or between regions of a country (Sub. 16, p. 5).

However, others view tax concessions as transitory and place little value on them. In discussions with the Reserve Bank, the Commission was told that Asia's tax 'holidays' have generally not succeeded in attracting Australian investment. The Australian Stock Exchange said:

> ... it would appear that inducements offered by a host country are not the determining factor but should be viewed rather as an added bonus (Sub. 6, p. 1).

Some participants said the lack of success of tax concessions in attracting investment was because the attractiveness of special incentives to firms is negated if the multinational corporation's home country merely allows a credit for the foreign tax paid, and extracts further tax up to the home country's corporate tax rate. This can occur if there are no tax sparing[12] provisions in place. In practice, tax sparing often applies to concessions provided by listed countries or those countries with which Australia has a double taxation agreement. It is less likely to apply to unlisted countries. BHP said:

> The CFC system needs to be amended so that tax incentives and concessions for active business should be afforded the same treatment in Australia whether the business is located in a listed or an unlisted jurisdiction. (Sub. 38, p. 9).

Where tax sparing provisions do not apply, tax competition leads to a transfer of tax revenue between governments — from the government of the country offering the concession to the home country government — and does not directly benefit firms. However, firms may still benefit from tax competition because, although the total corporate tax paid is the same, Australian resident shareholders receive greater franking credits reflecting the additional Australian company tax paid.

A particular problem with tax incentives is that they are usually selective, in the sense of not being available to all foreign firms. Hence, governments have to specify the activities, firms, regions and other circumstances under which they apply. However, to target successfully those activities which will maximise the potential benefits from making concessions available, the information requirements facing governments are daunting. They include information on future market developments, the effect of concessions on beneficiary firms and the likely actions of beneficiaries in future years (for example, whether they

[12] Under tax sparing provisions, a credit can be provided for tax *deemed* to have been paid in a foreign country.

could easily relocate again to countries offering greater concessions). In practice, such comprehensive information is rarely, if ever, available. This raises the very real possibility that governments will 'get it wrong' and that the community as a whole will be worse off with the concession than otherwise. At the Tax Round-table, Mr Peter Wilson of the New Zealand Treasury said:

> ... we'll always get it wrong if we try and target sectors because we don't know the elasticities so we just give that up, just have a single rate, tax all sectors the same ... that has costs, but it has less costs than trying to do the alternative.

Taxation incentives are generally provided by countries with an investment environment which, without the incentives, would not be as attractive to foreign investment. The OECD (1995b), discussing the role of special tax incentives in the newly developing Eastern European countries, said:

> The experience with tax incentives in the region has been consistent with that of the OECD countries. Tax incentives have not been successful in attracting FDI. This underlines the conclusion that tax incentives cannot overcome the other more fundamental problems which are inhibiting investment (p. 10).

The OECD also found that, rather than conferring benefits, "tax incentives had imposed serious costs on the countries in the region" (p. 10). These included revenue losses, tax avoidance, additional complexity of the tax system, mis-targeting and tax planning.

Assessment

The level of corporate tax in Australia relative to that prevailing in other countries is clearly a relevant policy concern. Participants indicated that statutory tax rates do influence their investment location decisions. They are also relevant to the extent that other countries allow tax credits for foreign taxes paid. In these circumstances, it is in Australia's interest to tax up to the creditable limit. There are also compliance concerns: for instance, if Australian corporate tax is high relative to that in other countries, there is an incentive for multinational corporations to engage in illegal transfer pricing which, if undetected, would erode Australia's tax base.

However, competing with other countries on tax has many pitfalls, not the least of which is the inability to influence other countries' tax rates. In this context, at the Tax Round-table, Mr Wilson further commented:

> ... there are risks and costs to setting your tax policy on the basis of what other countries do if you can't influence what they do ... but how do you know that Singapore is not going to change their rate tomorrow?

In determining corporate tax rates, it is also important to consider broader government economic and social objectives. As another participant at the Round-table, Professor Freebairn (in CEDA 1994), said:

> Just because Hong Kong, for example, decides not to spend significant amounts of public money on things like infrastructure and health, do we want to do the same? If we have lower taxes on business we either have to spend less on things such as infrastructure and health or else increase taxes on labour. What Hong Kong wants to do is Hong Kong's business, but it shouldn't be the model that we automatically follow. We have to look at what's best for Australia (p. 59).

It is clearly advantageous for Australia to have the lowest corporate tax rate consistent with meeting the overall objectives of government. But this does not imply that the *sole objective* of taxation policy in Australia should be to achieve tax rates lower than those of our trading partners. Australia's taxation of corporate income should be determined with a view to achieving the most efficient and equitable structure for the taxation system as a whole, while raising the revenue required to meet Australia's economic and social objectives.

Dividend imputation

Australia's system of imputation is not a 'fully integrated' system in the sense that all the tax characteristics of income and losses derived at the corporate level are allocated to shareholders. For instance, where dividends are paid out of non-taxable income, the non-taxable nature of the income does not pass to shareholders. In these situations, there are no imputation credits and shareholders pay tax on the dividends at their personal marginal tax rate. The main reasons for limiting the system in this way are to limit the risk of fraud, to reduce the cost to revenue and reduce administrative costs. Similarly, imputation credits are not available for corporate tax paid overseas on foreign-sourced income. Thus, individual Australian shareholders pay tax at their personal marginal tax rates on dividends paid by Australian companies out of foreign-sourced income.

Participants generally were supportive of dividend imputation. For instance, the Minerals Council of Australia said:

> ... the Council strongly endorses the current dividend imputation system ... We see this as a very important part, and a permanent feature of, the taxation landscape (Transcript, p. 17).

However, in the context of ADIA, some participants saw scope for improvements. Two particular aspects of Australia's dividend imputation system attracted comment. One is concerned with what is generally known as 'streaming'. The other is the lack of imputation credits for foreign-sourced income.

International dividend streaming

Under the existing legislation, when a distribution is made, all shareholders must receive the same proportion of franked and unfranked dividends. One consequence is that non-resident shareholders will generally receive some franked dividends which are exempt from Australian withholding tax. For those non-residents whose governments grant a credit for foreign withholding tax, this exemption is of no value, and the franking credits are, in a sense, 'wasted'. At the same time, resident shareholders may receive some unfranked dividends on which tax is payable at the shareholders' full personal marginal tax rates.

Participants' views

Participants at the Tax Round-table, as well as many other inquiry participants, considered the inability to allocate franked dividends to those shareholders who can utilise them, and unfranked ones to those who cannot, to be a significant impediment for Australian companies wishing to invest offshore. Pioneer said:

> Pioneer's dilemma is that the Dividend Imputation System, which is highly attractive to its Australian shareholders, acts as a disincentive to overseas investment, which is vital for the company's expansion (Sub. 4, p. 10).

A solution proposed by some participants is to permit 'streaming'. Streaming is the term applied to the practice whereby imputation credits are directed, or 'streamed', only to those shareholders who can use them to reduce their tax liability.

In the context of this inquiry, streaming is most relevant to dividend payments made by Australian resident multinational corporations having both resident and non-resident shareholders. If streaming were permitted under such circumstances, Australian multinational corporations would be able to pay franked dividends to Australian shareholders, with unfranked dividends being directed to non-resident shareholders. This would make shares in Australian multinational corporations more attractive to Australian resident shareholders. Burns Philp said:

> At present approximately 50% of our shares are foreign owned so franking credits ascribed to Australian shareholders are effectively at 50% of their potential level under streaming arrangements. The ability to stream credits arising from Australian tax paid fully to local shareholders would ascribe greater value to our shares (Sub. 10, p. 1).

Arguments for and against anti-streaming rules

When imputation was introduced in Australia in 1987, the streaming of franking credits was not expressly prohibited, and various schemes were introduced by companies which enabled shareholders to choose between franked and unfranked dividends.[13] When anti-streaming rules were introduced in 1990, these schemes did not become illegal, and they continue to be used. However, while foreign shareholders can still receive ‘unfranked’ dividends, there is now an offsetting cost to the company because it loses an equivalent amount of franking credits.

Under the present arrangements, Australian companies with only Australian operations enjoy a tax advantage over Australian multinational companies. This advantage arises because, at the shareholder level, offshore income is subject to both foreign and Australian tax. Hence, as Australian firms increase their foreign-sourced income, the rate of tax paid (Australian plus foreign) by their Australian shareholders also increases, irrespective of whether streaming is permitted. This is an inevitable consequence of, in broad terms, basing the taxation of international income at shareholder level on NN principles.

Permitting international dividend streaming would make Australian shareholders of companies having both resident and non-resident shareholders better off compared with a situation of no streaming. However, the key issue is whether or not this would improve economic efficiency.

As pointed out by the Commonwealth Treasury, the efficiency effects of the anti-streaming measures depend largely on the nature of a firm’s planned overseas investments.

In the case of a firm planning an overseas investment financed by *foreign* equity capital, it is possible that the anti-streaming provisions could result in some firms abandoning the investment in favour of an alternative domestic investment which, from a national perspective, would yield a lower rate of return (see Box 5.5). This outcome reflects the current requirement to distribute franking credits equally between all (resident and non-resident) shareholders. If streaming were permitted, franking credits could be directed to Australian shareholders. This would increase resident shareholders’ after-tax returns and encourage the company to proceed with a new overseas investment which would generate a

[13] One example of such a scheme is ‘stapled stock’. Under stapled stock arrangements, an investor buying a share in an Australian company also, automatically, obtains a share in an associated offshore company. The shares are ‘stapled’ together and cannot be traded separately, but shareholders can choose from which company to receive their dividend. In the case of the Brambles Group, this enables non-resident shareholders to take advantage of the United Kingdom imputation system and thus receive tax credits.

higher rate of return for Australia as a whole than would the alternative domestic investment. In this situation, the Treasury said:

> This is a circumstance where allowing international dividend streaming may improve efficiency (Sub. 48, p. 3).

In a recent paper, the BIE (1996) also found that there is a case for streaming in these circumstances (investments which it characterised as generating 'pass-through' income) because:

> ... the merger/takeover generates an increment of pass-through income which causes their franking credits to fall. The consequence is that both shareholder returns and company growth are disadvantaged ... (p. 57).

An example of the incentives provided by the current tax arrangements to avoid new overseas investments financed by foreign equity was provided at the Tax Round-table by Mr Philip Anderson of Arthur Andersen, in relation to a hypothetical merger between an Australian and a United Kingdom firm:

> You've got an Australian company that does certain things totally within Australia, and it merges with a UK company which does similar things totally within the UK, and you put them together. Essentially all shareholders have the same type of stock but the UK shareholders also have a share in the UK company which is stapled to the overall share and provides no rights other than to draw profits from the UK activities. UK shareholders are totally indifferent to that because they can still have a streaming arrangement whereby they get imputation credits. The Australian shareholders are immediately worse off, even though nothing else has changed. I can't really see the equity or economic justification for that outcome.

On the other hand, an argument on efficiency grounds — which was not discussed in detail in the draft report — can also be made for not permitting streaming. More specifically, streaming could encourage some firms planning new overseas investment financed by new *domestic* equity to pursue such projects at the expense of domestic projects which would be more profitable from the community's viewpoint. Box 5.5 shows that, in the absence of streaming, the average after-tax return to Australian shareholders would be reduced by this type of new overseas investment, making it unattractive to resident shareholders. If streaming were permitted, the return to Australian shareholders from a new foreign investment would be artificially increased (relative to the NN benchmark), making it likely that it would proceed. Thus, in some situations, streaming would provide an incentive for firms to undertake new overseas investments which would yield a lower return to Australia as a whole than would alternative domestic investments.

Arthur Andersen supported the view that, in some circumstances, streaming would reduce efficiency. However, it considered that, in practice, such circumstances would rarely occur:

> It would appear that the case [demonstrating efficiency losses if streaming is permitted] is a special case. It is also a fairly rare case (Sub. 53. P. 5).

Consequently, Arthur Andersen expressed the view that the benefits from permitting streaming would be likely to outweigh the costs, which it saw as being confined to a relatively small number of investments:

> ... while there may be some cases where the revenue could be disadvantaged by dividend streaming, the disadvantage is not such that it could be systematically exploited, and hence give rise to significant revenue losses ... the general thrust is that dividend streaming would improve the competitiveness of Australian based companies in foreign investments, and hence lead to greater integration of Australian based companies into the global economy (Sub. 53, p. 6).

In support of its claims, Arthur Andersen cited a range of circumstances in which it argued that, if streaming were allowed, Australia would not be disadvantaged.

Analysis of the effects of streaming is complex. It necessarily involves judgments about the nature of companies investing offshore (for example, the composition of their shareholding) and the characteristics of new overseas investment (for example, the funding arrangements). While the Commission agrees with a number of the points made by Arthur Andersen, it is not convinced that adverse efficiency effects would be confined to only isolated projects.

Box 5.5: Effects of international dividend streaming

The effects on shareholders and Australia as a whole of permitting international dividend streaming are summarised below in relation to hypothetical new overseas investments by two Australian companies, financed by, first, foreign equity and, second, domestic equity. The supporting calculations are shown in detail in the addendum to this chapter.

Example 1: New foreign investment financed by *foreign* equity

An Australian firm, with some non-resident shareholders, is planning a new overseas investment financed by a share issue to foreign investors. The expected returns for the company as a whole and Australia, before the new investment and after – both with and without streaming – are shown below:

Return to:	*Before the new investment; no streaming*	*After the new investment: no streaming*	*After the new investment: streaming*

Resident shareholders (%)	8.3	8.1	9.3
Australia as a whole (%)	17.9	18.3	18.3

In this scenario, in the absence of streaming the new foreign investment would lower shareholders' return. Thus, the company may elect not to proceed with the venture, even though it provides a relatively high return for Australia as a whole. Permitting streaming would make the investment profitable both for Australian resident shareholders and for Australia as a whole.

Example 2: New foreign investment financed by *domestic* equity

An Australian firm, with some non-resident shareholders, is planning a new overseas investment financed by a share issue to domestic investors. The expected returns before and after the new investment in the absence of streaming, and after the new investment with streaming permitted, are shown below:

Return to:	*Before the new investment: no streaming*	*After the new investment: no streaming*	*After the new investment: streaming*
Resident shareholders (%)	8.3	8.1	9.1
Australia as a whole (%)	17.9	16.8	16.8

In this example, the return to domestic shareholders is reduced and the investment may not proceed. However, if streaming were permitted, shareholders' returns would increase significantly. This could lead to a situation where foreign investments proceed ahead of domestic investments which, from Australia's perspective, would provide a higher rate of return.

In principle, it would be most efficient to permit streaming in those cases where it would enhance efficiency and to disallow it in those instances where it would reduce efficiency. However, with companies continually acquiring and disposing of assets, raising new equity and changing ownership structures, it would be administratively difficult, and costly, to quarantine streaming in this way. Furthermore, there would be an incentive for firms to have existing overseas investments categorised as 'new' investments by (say) changing ownership structures in order to broaden the application of streaming. It would be exceedingly difficult to detect such practices.

If it could be demonstrated that allowing streaming to apply to all new investments could result in net benefits, an alternative policy option would be to permit international dividend streaming in all instances. However, there is no evidence that this would be the case. As the Treasury said:

> ... it is by no means clear that this cost [of deterring efficient investments] would be larger than the economic cost of allowing international dividend streaming in some cases where domestic equity capital is employed. (Sub. 48, p. 4).

Another possible — and often stated — argument against the streaming of franking credits is that it violates equity. In that context Preston (1995) said:

> Dividend streaming ... offends the principle that all classes of shareholder — whatever their effective Australian tax rate — should be taken to participate equally in the income of the company (p. 58).

Similarly, Brambles — which favours international dividend streaming —said non-resident shareholders would be disadvantaged because a higher proportion of their dividends would be unfranked, and hence subject to dividend withholding tax. To avoid this situation, the company suggested that, in addition to permitting streaming, all pass-through dividends should be exempt from dividend withholding tax.

Dividing the available franking credits equally over all shareholders may be viewed as contributing to an equity objective. However, the Commission has reservations about the validity of this argument, mainly because the imputation system itself, consistent with NN principles, already treats residents differently from non-residents.

Another rationale given for not permitting streaming is the associated revenue loss. In the Second Reading speech, it was stated that the anti-streaming measures would:

> ... prevent the erosion of potentially significant, but unquantifiable, amounts of revenue (Commonwealth of Australia 1990, p. 182).

The Treasury said that, while the imputation system had improved economic efficiency substantially by removing the double taxation of dividends for domestic investment, and provided substantial benefits for investors, this had been:

> ... at a cost to revenue when compared to the former 'classical system' that taxed dividends twice ... The cost to revenue was ameliorated to some extent by not allowing the streaming of dividends (Sub. 48, p. 1).

At the Tax Round-table it was suggested that permitting international dividend streaming might not be very costly, because at least some non-residents currently receiving franked dividends exempt from withholding tax would instead receive unfranked dividends and be levied withholding tax.[14] While

[14] Those non-resident shareholders who are able to receive profits in a 'non-dividend' form (through the use of stapled stock arrangements, equity-debt swaps, securities lending arrangements and the like) would still not be subject to dividend withholding tax.

disadvantaging those non-residents whose governments do not grant credits for foreign dividend withholding taxes, this would offset revenue losses arising from diversion of franking credits to resident shareholders. However, to the extent that there is a revenue loss, there would need to be a commensurate reduction in government expenditure or a compensating increase in other taxes.

Conclusion

There does not appear to be a case for permitting international dividend streaming for new overseas investments financed by *domestic* equity. In principle, there *is* a case for permitting international dividend streaming of new overseas investments financed by *foreign* equity. However, in practice, it would be administratively difficult to limit the use of streaming to such projects. In these circumstances, it is unclear whether the benefits of permitting streaming would outweigh the costs. The Commission accordingly does not support the introduction of international dividend streaming.

Extending imputation credits for foreign corporate taxes

Australian shareholders of companies operating overseas do not receive credits for the foreign tax paid on the income out of which their dividends are paid. Consequently, from the shareholders' perspective, a domestic investment would (other things being equal) yield a higher return than an offshore investment. While supporting the imputation system, the MCA saw that as a disadvantage:

> The present imputation system ... places Australian companies with overseas operations at a disadvantage in that shareholders receive no imputation credit for foreign taxes paid on offshore operations. The system taxes foreign income more harshly than domestic income (Sub. 42, p. 5).

The present system also provides an incentive for the reinvestment of foreign profits overseas, although this incentive is offset to some extent by the capital gains tax provisions. For instance, the ACM said that, because the tax paid on profits from overseas branches does not give rise to franking credits in Australia, this:

> ... results in [those] profits ... being taxed at 71 % to shareholders and encourages Australian firms to retain these profits overseas for further investment, rather than to return the profit to Australia for investment or distribution (Sub. 7, p. 9).[15]

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[15] In the example in Box 5.3, the effective tax rate for shareholders on foreign-sourced income under NN-based taxation is 73 per cent. In reality, this can be higher or lower depending on foreign tax rates and whether the income is earned in a listed or unlisted country.

While it is true that the system provides some incentive for the reinvestment of foreign profits overseas, the bias in favour of investment in Australia is a deliberate design feature of the imputation system. By, in effect, treating tax paid overseas as a deduction, the present imputation system is broadly consistent with taxation on the basis of NN, and consistent with maximising the benefits of ADIA to the Australian community as a whole.

Any action to modify the imputation system to provide credits for foreign tax paid, or to make foreign-sourced dividends tax exempt, would, in the Commission's view, not be in Australia's best interests.

Dividend withholding taxes

The rate of withholding tax depends on whether a double taxation agreement (see Box 5.6) is in place between Australia and the country in which non-resident shareholders reside. Before the advent of these agreements, often both the host country and the shareholders' country of residence imposed taxes on dividend income. This double taxation was seen as having an adverse effect on international capital flows. Nevertheless, when 'assigning' the rights to tax dividend income in its Model Tax Convention, the OECD said it was neither acceptable to tax dividends exclusively in the host country, nor feasible to tax dividends exclusively in the beneficiary's country of residence. It therefore recommended a limited tax in the host country, with the residual right to tax allocated to the beneficiary's country of residence (OECD 1994c).

The rates of withholding tax recommended for host countries in the Model Tax Convention are a maximum of 5 per cent when the beneficiary is a corporate shareholder and a maximum of 15 per cent in all other cases. With regard to the latter situation, the OECD said:

> A higher rate could hardly be justified since the State of source can already tax the company's profits (p. C(10)-3).

About the lower rate, when the beneficiary is a company, it said:

> ... it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment (p. C(10)-3).

Notwithstanding these recommendations, Australia has always reserved the right to tax, at a rate of not less than 15 per cent, dividends paid by a company that is a resident of Australia. As a result, withholding tax imposed on dividends remitted to non-residents is high compared with that levied by other countries. However, there is an offset (described previously) in that, under Australia's imputation system, overseas recipients of dividends generated in Australia are subject (in Australia) to withholding tax only on unfranked dividends. Hence, non-residents receiving only franked dividends pay no withholding tax.[16]

On the other hand, Australian resident companies receiving dividends from their subsidiaries overseas are generally subject to withholding tax of 15 per cent on those dividends (under the reciprocal treaty arrangements). To the extent that Australian multinational corporations face a higher effective level of withholding tax than do corporations resident elsewhere, they are at a competitive disadvantage. There is also a view that the imposition of the tax acts as an impediment to repatriating profits to Australia. In a submission to the ATO, Brambles said:

> ... the high dividend withholding tax rate of 15%, which is the predominant rate in Australia's double tax treaties clearly acts as a deterrent to the repatriation of offshore profits/cash to Australia and thus is not in the economic interests of Australia, or Australian multinationals and their shareholders (Attachment to Sub. 34, p. 4).

Box 5.6: Model tax conventions

The first model bilateral tax convention making recommendations for the elimination of double taxation was drawn up in 1928 as a result of work done by the League of Nations. This was followed by the Model Conventions of Mexico in 1943 and the Model Convention of London in 1946.

As capital movements increased, it became obvious that there was a need for uniform principles and agreement on their interpretation. Following the publication of a Draft Convention in 1963, the OECD published *The Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital* in 1977. In 1991, the OECD Committee on Fiscal Affairs adopted the concept of an 'ambulatory' model, providing updates rather than complete revisions.

As investment flows from developed to developing countries grew, it became clear that some aspects of the OECD model were not entirely appropriate in negotiations between developed and developing countries. As a result, the United Nations, assisted by a Group of Experts, prepared the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.

Both models represent a compromise between the residence and the source principles of taxation, with the UN model giving relatively more weight to the latter. This appears to be

[16] As noted earlier in this chapter, another category of dividends exempt from Australian withholding tax are those paid out of pass-through income and which qualify for an exemption under the provisions which came into force on 1 July 1994.

based partly on notions of equity: developing countries are perceived to be less able to afford to 'give up' taxation revenue to residence countries than are developed countries.

The provisions of the models are intended as a guide for negotiations and are not binding. Within that limitation, they establish, with regard to different classes of income and capital, the taxation rights of the source country and the residence country. In some instances, they confer an unlimited right to tax on one of the contracting countries (for instance, in the case of business profits), in others they limit the right to tax by one of the contracting countries to a certain percentage (for instance, in the case of dividends).

The models also deal with "transactions between associated enterprises" (transfer pricing), providing that the taxation authorities of a contracting country may adjust the accounts of an enterprise if they do not show the true taxable profits arising in that country. Other special provisions relate to: non-discrimination between nationals of the contracting states with regard to the burden of tax; the period the agreement shall be in force; and the termination of agreements.

Sources: OECD 1994c and UN 1980.

BHP said:

> Australia does not deduct withholding tax on franked dividends paid to overseas countries and yet Australian investors in overseas countries are subject to dividend withholding tax by virtue of out-of-date tax treaties. Urgent attention, therefore, needs to be given to renegotiating the dividend withholding tax clauses in Australia's International Tax Treaties (Sub. 15, p. 9).

In the past, when ADIA was minor relative to direct investment by foreigners in Australia, it may have made good sense to negotiate a withholding tax of 15 per cent. However, now that Australia is also a significant exporter of capital, the rationale for maintaining withholding tax on corporate dividends at 15 per cent is weaker. It also needs to be recognised that Australia's imputation system results in no withholding tax being paid on franked dividends remitted to foreign shareholders.

The Commission understands that achieving a zero rate of dividend withholding tax is now official Government policy in respect of non-portfolio dividends. However, the ATO said:

> To date no country has been prepared to agree to a reciprocal zero rate, although a number have agreed to a 5% rate limit in respect of non-portfolio dividends (Sub. 29, p. 3).

The most recently completed (or revised) agreements (with the Czech Republic, Romania, Russia and Germany) have incorporated a rate of 5 per cent on non-portfolio dividends.

Reducing the level of withholding tax to 5 per cent on a reciprocal basis may not be appropriate in all cases. For instance, in the case of countries from which Australia is a large net importer of capital, reducing the level of withholding tax could have significant revenue implications.

The ATO said that all existing treaties are being progressively reviewed, seeking a lower level of dividend withholding tax. However, there are some difficulties. One is that renegotiating double taxation agreements is time-consuming. Also, countries are reluctant to re-open negotiations for a change to only one Article. To overcome the need for full treaty renegotiation, Telstra suggested that:

> ... any change to dividend withholding tax rates in agreements be carried into force by way of protocols to agreements (Sub. 33, p. 2).

Another problem, indicated by the ATO, was that:

> Some countries have indicated they would seek additional treaty benefits in order to grant such reciprocal DWT treatment, given that Australia has unilaterally forgone withholding tax on franked dividends (Sub. 29, p. 3).

While recognising that there can be difficulties in renegotiating the double taxation agreement with some countries, the Commission recommends that all existing double taxation agreements be reviewed as soon as possible to assess whether it would be appropriate for Australia to seek to negotiate a lower level of withholding tax.

Account would need to be taken of the fact that some countries allow their residents a credit for foreign withholding tax (but not for foreign corporate taxes). In these circumstances, reducing withholding tax would be of no advantage to foreign investors (because they would receive the same after-tax income) — it would result merely in a transfer of tax revenue from Australia to the foreign government.

To accommodate such circumstances, New Zealand has introduced a system which effectively negates the incidence of withholding tax, but preserves the capacity of foreign shareholders to receive a credit in their own country. Under this system — known as the ‘foreign investor tax credit’ regime — non-resident investors receive a ‘supplementary’ dividend, calculated according to a formula which takes into account the rate of withholding tax payable, and equal to just over half of the imputation credits attached to the dividends. This leaves the total tax paid by non-residents on their New Zealand-sourced dividend income

— company tax plus withholding tax — equal to the normal rate of company tax. But those non-residents whose governments grant a credit for foreign withholding taxes will have paid in New Zealand effectively only the equivalent of just under half the rate of company tax.

Administrative arrangements

It is widely held by the business community that the Australian taxation system is unduly legalistic and lacks flexibility. Many consider that compliance costs are too high. Compliance costs in this context comprise the costs of:

- company staff collecting and maintaining tax information, completing tax forms and dealing with professional advisers and the ATO; and
- external financial costs (for example, professional fees of tax agents, accountants, lawyers and other advisers).

Compliance costs

Few studies have investigated compliance costs in Australia. A study by Pope, Fayle and Chen (1990) suggested that compliance costs in Australia are high relative to those in the United Kingdom. However, a recent Industry Commission staff paper (Rimmer and Wilson 1996) found that caution should be exercised in interpreting the results of the Pope study as low response rates and possible sampling errors may have led to an overstatement of compliance costs. One finding, which is supported by international research is that compliance costs are regressive, and a good deal higher than the administrative costs of the ATO.

Areas specifically identified by participants in this inquiry as involving high compliance costs are the CFC measures and transfer pricing.

CFC rules

While some participants acknowledged that the CFC rules provide significant benefits by exempting dividends from listed countries from Australian tax and excluding attribution of ‘active’ business income from unlisted countries, they are also said to have increased compliance costs significantly. For instance, Pioneer said:

> For Pioneer, a report of between 15 and 25 pages ... has been developed to collect the information required to satisfy the Australian Tax Office that the company has complied ... Over 120 individual CFC reports must be prepared by Pioneer’s overseas operations and forwarded back to Australia (Sub. 4, p. 12).

The Commission was told that, in some cases, the information provided in these reports is insufficient and may have to be followed up with a longer and more detailed report.

Some participants at the Tax Round-table said that the need to prepare a separate set of accounts for tax purposes is one of the reasons for compliance costs being higher in Australia than in some European countries, where tax assessments are based on the normal, audited books of account.

The Treasury agreed that the CFC rules are complex, but it said that is in the nature of CFC regimes and not unique to the CFC rules in Australia. Having been introduced largely as an anti-avoidance measure, the Treasury said that the CFC rules:

> ... need to be robust if they are to be effective. Ineffective CFC rules would produce the worst outcome; companies would still face compliance costs but the objective of the rules would not be achieved (Sub. 48, p. 6).

However, the Treasury agreed that there was merit in a systematic review of the present requirements to assess whether compliance costs could be reduced without impairing the effectiveness of the rules.

Transfer pricing

Transfer prices are the prices charged for transactions between associated enterprises. Because the transactions are not entered into at ‘arm’s length’, there is the potential for the prices charged to be manipulated to shift profits between related enterprises. When the parties involved are located in different countries, with different corporate tax rates, transfer pricing can be used to minimise companies’ total tax liability. The greater the difference between countries’ corporate tax rates, the greater the incentive to manipulate transfer prices. In Australia, any incentive to use transfer prices to shift profits *out of* Australia is, to an extent, offset by the operation of the imputation system. That is because the preference of Australian equity holders for franked dividends creates an incentive to increase profits in Australia. Nevertheless, by its nature, the cost to revenue from transfer pricing is difficult to estimate.

The potential for transfer pricing to erode the revenue base has prompted governments in most countries to pass legislation seeking to have transactions between related parties priced at values which reflect normal market prices. However, some participants claim that the documentation required by the ATO to monitor transfer prices is excessive. One view put to the Commission is that the cost of the additional resources now devoted by the ATO and affected companies to transfer pricing exceeds the additional revenue collected. Others contend that the ATO is pursuing the Government’s transfer pricing policies with excessive zeal and creating inconsistencies and uncertainty, especially where lengthy audits are involved. It was claimed that, in some instances, audits can take as long as five years. Uncertainty about how the rules will apply was also cited as a problem. The MTIA said:

> Transfer pricing has significantly increased levels of uncertainty as businesses struggle to come to grips with the voluminous rulings and the associated evidentiary requirements. There has also been a substantial increase in the regulatory burden associated with the transfer pricing issue (Sub. 9, p. 6).

Telstra said:

> We therefore consider that the views espoused in the draft report that the ATO reporting requirements in this regard [transfer pricing] result in unduly high compliance costs is correct. We support a review of the present arrangements with a view to reducing the administration and compliance costs (Sub. 33, Attachment A, p. 3).

The ATO said transfer pricing is currently seen as one of its major strategic issues. It said that in its experience:

> ... many multinational taxpayers have not even addressed the question of whether their dealings satisfy the arm's length principle let alone addressing the question of other practical compliance obligations such as record keeping requirements (Sub. 29, p. 2).

The ATO also said it is going through the process of reducing the length of the rulings to focus more on the main principles. It contended that taxpayers can reduce compliance costs and the risk of lengthy audits by entering into an Advance Pricing Agreement with the ATO. These arrangements involve both the taxpayer and the ATO agreeing on an appropriate arm's length transfer pricing methodology. The arrangements are reviewed after five years, or earlier if there are substantial changes in market conditions. Telstra said the process of obtaining an Advance Pricing Agreement was costly and time-consuming.

Burns Philp suggested the ATO should, as New Zealand and the Netherlands have done, adopt an "80/20" rule. This rule is based on the experience of 80 per cent of the taxation revenue generally being collected with only 20 per cent of the effort, rendering the collection of the last 20 per cent of revenue too costly.

Conclusion

Given the broad-ranging nature of taxation measures, some degree of complexity seems inevitable. However, beyond that, there appear to be two main policy choices. First, a government can opt for a system of minimal complexity by not fully prescribing in legislation the arrangements that will apply in every circumstance. This simplifies legislation and may also reduce compliance costs. However, an inevitable consequence of this approach would be an increase in bureaucratic discretion, increased uncertainty and reduced transparency in taxation policy.

The second approach — which more closely approximates the Australian system — is to expose the taxation requirements to the maximum degree of possible scrutiny by enacting detailed legislation and specifying in detail (for example, in tax rulings) what is required of firms.

In essence, the choice between these alternatives involves a trade-off between complexity and transparency.

While the Commission supports making the taxation system as transparent as possible, it is clearly important that, consistent with that objective, compliance costs be minimised. It seems likely that that is most efficiently achieved through ongoing negotiations between the ATO and industry.

ATO reporting requirements in relation to CFC rules and transfer pricing add significantly to business perceptions that compliance costs in Australia are unduly high. The available evidence supports the case for a systematic review of the present requirements, including an assessment of the cost-effectiveness of pursuing a less rigorous approach in areas where compliance and/or administration costs are high. Such a review should include a detailed study to determine how compliance costs in Australia compare with those in comparable overseas countries.

The Commission recognises that a number of projects are currently under way. One is the Tax Law Improvement Project (TLIP), a three-year project which was commenced in early 1994. It is aimed at making the existing law easier to understand, rather than about changing tax law. The Commission has made a submission to the TLIP suggesting that, unless the ATO is able to identify which areas of the tax system entailed the highest compliance costs, it would not be able to target its activities efficiently under the TLIP.

The ATO has also begun preparing Tax Impact Statements. However, these are not concerned with existing taxation rules, but aim to estimate the compliance costs associated with changes in taxation measures. Lastly, a Small Business Deregulation Task Force has been established with a mandate to review, amongst other things, ways of reducing, in a revenue-neutral manner, taxation compliance costs for small businesses by 50 per cent. The Task Force is required to report to the Prime Minister by 1 November 1996. The Government also plans to appoint a statutory body — the Australian Taxation Advisory Council — to assist in making the ATO more responsive to its clients.

To help clarify the tax law with regard to transfer pricing, and to assist with compliance requirements, the ATO has been involved in the OECD task force on transfer pricing guidelines (see Sub. 29). Other ATO initiatives have included a series of presentations to industry representatives and professional bodies, and the establishment of a Taxation Liaison Group subcommittee which provides input into transfer pricing rulings.

ADDENDUM

Effects of international dividend streaming: stylised examples

This addendum illustrates how the rates of return reported in Box 5.5 were derived. It shows how streaming the domestically sourced income of Australian multinational corporations to Australian resident shareholders, and the foreign-sourced income to non-resident shareholders, can change the rate of return received by resident shareholders. The outcomes vary depending on whether the planned new overseas investment is financed by foreign or domestic equity.

The initial scenario

Initially, the Australian multinational corporation is assumed to have total investments of $1200, with $1000 located in Australia and $200 overseas. Two-thirds of the shareholders (66.7 per cent) are Australian residents, so that total Australian equity is $800 (two-thirds of $1200).

The rate of return on both the company's investments in Australia and in the foreign location (after foreign tax[17]) is assumed to be 15.6 per cent. The foreign location is assumed to be in a listed country, so no further Australian company tax is payable on the foreign income. The company's Australian tax liability of 36 per cent results in profits becoming available for distribution as follows:

	Australia	*Foreign*	*Total*
	$	*$*	*$*
Amount invested in each location ($A)	1000	200	1200
Profits before Australian tax (15.6%)	156	31	187
Australian company tax (36%)	56	n/a	56
Net profits available for distribution	100	31	131
Franking credits generated	56	n/a	56

Australian resident shareholders receive dividends in keeping with their equity — 66.7 per cent of the company's net profit ($87). Because streaming is not permitted, their dividends are deemed to be sourced from both the Australian

[17] Including foreign dividend withholding tax if applicable.

and the overseas earnings, again in accordance with their equity in the company. Thus, resident shareholders are entitled to dividends of $67 and $20 from local and overseas earnings, respectively. Because they receive 66.7 per cent of the Australian-sourced profits, resident shareholders also receive 66.7 per cent of the franking credits ($37). To calculate the Australian shareholders' personal income tax liability the dividend received is 'grossed up' by the amount of the franking credit. The Australian shareholders' personal marginal tax rate is assumed to be 47 per cent. Under these circumstances, the rate of return received by Australian resident shareholders is as follows:

	$
Received by Australian shareholders (66.7% of $131)	87
Australian share of franking credits (66.7% of $56)	37
Grossed up income ($87+$37)	124
Personal income tax (47% of $124)	58
Additional tax payable ($58-$37)	21
Net received by Australian shareholders ($87-$21)	66
Shareholders' rate of return ($66/$800x100)	**8.3%**

The return to the Australian community includes not only the net income received by the resident shareholders, but also the tax paid in Australia. The return to Australia as a whole is calculated as follows:

	$
Net received by resident shareholders	66
Company tax paid	56
Additional personal income tax paid	21
Total received by Australia	143
Australia's rate of return ($143/$800x100)	**17.9%**

In summary, the rate of return to Australian resident shareholders before the company undertakes a new investment is 8.3 per cent, and that to the Australian community 17.9 per cent.

New foreign investment financed by *foreign* equity

Assume that the company plans a new investment in the foreign location of $200, financed by a share issue to non-resident shareholders. The total amount invested in both locations combined will increase to $1400. The number of Australian shareholders will not change, so neither will the total amount of Australian equity ($800). However the proportion of Australian resident shareholding will fall to 57.1 per cent ($800/$1400x100).

The return earned by the company on the additional investment is assumed to be slightly lower than the return on the existing foreign investment, resulting in an average return on the foreign component of the company's investments of 14.2 per cent (after foreign tax). The return on the Australian component of the company's investment is unchanged. The company will then have distributable profits as follows:

	Australia	*Foreign*	*Total*
	$	*$*	*$*
Amount invested in each location ($A)	1000	400	1400
Profits before Australian tax*	156	57	213
Australian company tax (36%)	56	n/a	56
Net profits available for distribution	100	57	157
Franking credits generated	56	n/a	56

*Australia 15.6%, foreign 14.2%

Australian resident shareholders receive 57.1 per cent of the total profits of $157 ($90). In the following sections, the rates of return to Australian resident shareholders, and to Australia as a whole, are calculated; first under the current conditions (streaming not permitted), and subsequently assuming that streaming is permitted.

Streaming not permitted

If streaming is not permitted, the Australian resident shareholders must receive 57.1 per cent of the Australian-sourced profits of $100 ($57), and 57.1 per cent of the foreign-sourced profits of $57 ($33). Because they receive 57.1 per cent of the Australian-sourced profits they will also receive 57.1 per cent of the franking credits. Their rate of return is calculated as follows:

	$
Received by Australian shareholders (57.1% of $157)	90
Australian share of franking credits (57.1% of $56)	32
Grossed up income ($90+$32)	122
Personal income tax (47% of $122)	57
Additional tax payable ($57-$32)	25
Net received by Australian shareholders ($90-$25)	65
Shareholders' rate of return ($65/$800x100)	**8.1%**

The return to the Australian community is as follows:

	$
Net received by resident shareholders	65
Company tax paid	56
Additional personal income tax paid	25
Total received by Australia	146
Australia's rate of return ($146/$800x100)	**18.3%**

Compared with the position before the new overseas investment was contemplated, the rate of return to the Australian resident shareholders has fallen (from 8.3 per cent to 8.1 per cent), while the rate of return to Australia as a whole has increased (from 17.9 per cent to 18.3 per cent).

Streaming permitted

With Australian-sourced profits available for distribution of $100, and the Australian shareholders' entitlement of the total profits being $90 (57.1 per cent of $157), there is sufficient Australian-sourced income for Australian resident shareholders to receive their dividends fully out of Australian-sourced income. Because the $90 they receive represents 90 per cent of the Australian-sourced profits, they also receive 90 per cent of the available franking credits of $56, equivalent to $50. Their rate of return is now calculated as follows:

	$
Received by Australian shareholders (57.1% of $157)	90
Australian share of franking credits (90% of $56)	50
Grossed up income ($90+$50)	140
Personal income tax (47% of $140)	66
Additional tax payable ($66-$50)	16
Net received by Australian shareholders ($90-$16)	74
Shareholders' rate of return ($74/$800x100)	**9.3%**

The return to the Australian community is as follows:

	$
Net received by resident shareholders	74
Company tax paid	56
Additional personal income tax paid	16
Total received by Australia	146
Australia's rate of return ($146/$800x100)	**18.3%**

Compared with the position before the new overseas investment was contemplated, the rate of return to the Australian resident shareholders has increased (from 8.3 per cent to 9.3 per cent), while the rate of return to Australia as a whole also has increased (from 17.9 per cent to 18.3 per cent).

Additional comments

One interesting result is that the return to Australia, after the new investment, rises to the same extent, whether streaming is permitted or not (17.9 per cent to 18.3 per cent). It is only the shareholders' returns which vary, falling without streaming, and rising with it.

The example assumes no streaming in the initial scenario. Had streaming been permitted in the base scenario also, the original rate of return to the Australian community would have been the same as that under no-streaming (17.9 per cent). The initial rate of return to Australian resident shareholders would have been higher than in the absence of streaming, but it would nevertheless be higher after the new investment. With streaming permitted both in the initial situation and after the new investment, the new investment would have been attractive to both the Australian resident shareholders and the Australian community. A summary of all the results is shown below:

	Streaming not permitted		*Streaming permitted*	
	Before investment	*After investment*	*Before investment*	*After investment*
	%	%	%	%
Shareholder return	8.3	8.1	9.0	9.3
Return to Australia	17.9	18.3	17.9	18.3

New foreign investment financed by *domestic* equity

Now assume that the company plans to finance the new investment by a share issue to Australian residents, rather than to non-residents. Before the new investment, the base scenario is as before: the returns to the Australian resident shareholders and the Australian community are 8.3 per cent and 17.9 per cent, respectively.

The total amount invested in both locations combined, as before, will increase to $1400. With the additional investment being financed by Australians, the amount of Australian equity will increase from $800 to $1000. The proportion of Australian shareholdings also will increase, to 71.4 per cent ($1000/$1400x100).

The return earned by the company on the additional investment is assumed again to be slightly lower than the return on the existing foreign investment, resulting in an average return on the foreign component of the company's investments of 14.2 per cent (after foreign tax). The return to the Australian component of the company's investment remains unchanged, at 15.6 per cent. Distributable profits will be the same as when the foreign investment was financed by foreign equity, being $157. Australian resident shareholders receive 71.4 per cent, or $112. The amount of available franking credits has not changed, being $56. The following sections show first the new rates of return with streaming not permitted, and subsequently with streaming permitted.

Streaming not permitted

The new return to Australian resident shareholders will be:

	$
Received by Australian shareholders (71.4% of $157)	112
Australian share of franking credits (71.4% of $56)	40
Grossed up income ($112+$40)	152
Personal income tax (47% of $152)	71
Additional tax payable ($71-$40)	31
Net received by Australian shareholders ($112-$31)	81
Shareholders' rate of return ($83/$1000x100)	**8.1%**

The return to the Australian community is as follows:

	$
Net received by resident shareholders	81
Company tax paid	56
Additional personal income tax paid	31
Total received by Australia	168
Australia's rate of return ($168/$1000x100)	**16.8%**

Compared with the situation before the new investment, the return to the Australian shareholders has fallen from 8.3 per cent to 8.1 per cent, and the return to Australia as a whole also has decreased, from 17.9 per cent to 16.8 per cent.

Streaming permitted

The Australian resident shareholders are entitled to $112 of the distributed profits, but there is only $100 of Australian-sourced profits. With streaming permitted, they will receive all the available Australian-sourced income ($100), as well as some of the foreign-sourced income ($12). Because they receive all the Australian-sourced income, they also receive all the franking credits ($56).

Rates of return to Australian resident shareholders and to Australia will be as follows:

	$
Received by Australian shareholders (71.4% of $157)	112
Australian share of franking credits (100% of $56)	56
Grossed up income ($112+$56)	168
Personal income tax (47% of $168)	79
Additional tax payable ($79-$56)	23
Net received by Australian shareholders ($112-$23)	89
Shareholders' rate of return ($89/$1000x100)	**8.9%**

The return to the Australian community is as follows:

	$
Net received by resident shareholders	89
Company tax paid	56
Additional personal income tax paid	23
Total received by Australia	168
Australia's rate of return ($168/$1000x100)	**16.8%**

Compared with the position before the new overseas investment was undertaken, the return to the Australian shareholders has increased (from 8.3 per cent to 8.9 per cent), while the return to Australia is the same as that under no streaming (16.8 per cent) and lower than before the new investment was undertaken.

Additional comments

The following shows the rates of returns achievable when the additional foreign investment is financed by domestic equity, both before and after the new investment, and both with streaming not permitted and with streaming permitted.

	Streaming not permitted		*Streaming permitted*	
	Before investment	*After investment*	*Before investment*	*After investment*
	%	*%*	*%*	*%*
Shareholder return	8.3	8.1	9.0	8.9
Return to Australia	17.9	16.8	17.9	16.8

Now contrast the case where the new foreign investment is financed by foreign equity with that when it is financed by domestic equity, and assume that streaming is permitted for the profits from the new investment but not for those from the initial investment. The outcome is that the rate of return to Australian resident shareholders increases (from 8.3 per cent to 8.9 per cent), while the rate of return to Australia falls. With streaming permitted both initially and after the new investment, the rate of return to shareholders falls slightly, while the rate of return to Australia falls more significantly.

6 LABOUR MARKET ISSUES

The literature, survey data and the views expressed by participants point to many reasons for Australian investment abroad. While most reflect commercial considerations — such as a need for an offshore presence to service market expansion — many firms are influenced by domestic regulations that are perceived to detract from Australia's attractiveness as a business location. One area which concerns many firms is government regulation of the labour market.

Most concerns centred not on wages, but on what were perceived to be onerous labour on-costs. In addition, many considered that the labour market institutional framework inhibits the adoption of work practices that are most suited to the needs of individual workplaces. The former can increase labour costs, whereas the latter constrains the ability of firms to improve competitiveness through productivity growth. According to participants, these influences have encouraged some firms to relocate offshore.

6.1 The influence of labour-related issues on ADIA

AEEMA and the MTIA identified labour costs as a reason for offshore investment. The MTIA, based on interviews with the chief executive officers of 30 member companies with operations offshore, reported that:

- the cost of employing labour and/or management is a significant factor in decisions to locate offshore for 28 per cent of companies — its importance as a cost factor increases as the degree of labour intensity increases; and
- labour on-costs are a significant factor in decisions to locate offshore for 68 per cent of the companies surveyed.

The MTIA added that the most frequently cited factor reducing productivity is 'workforce culture'. It considered that Australia's award system, lack of 'true' enterprise bargaining and a union preference for 'pattern bargaining' were key elements undermining the development of an appropriate workforce culture.

Mark One Apparel, which has operations in Australia and Fiji, said:

> Wage rates, workers' compensation, restrictive work practices, superannuation, payroll tax, holiday loading, dealing with unions, long service pay, redundancy liabilities and other regulatory restrictions have been good reasons to leave Australia for less developed countries (Sub. 17, p. 2).

Garmond Australia, a producer of picture frames, specified eight factors directing investment away from Australian manufacturing. The top four concerns were:

1 High labour costs
2 Inflexibility in the use of labour
3 Cost penalties for multiple shifts
4 Onerous legislation preventing effective adjustment of labour levels (Sub. 3, p. 1).

Several participants pointed to inefficient labour practices in Australian shipping and ports (see Chapter 9).

Most surveys seeking to identify the factors underlying decisions to locate offshore include labour issues in generic categories such as ‘cost-based motivations’ or ‘unit input costs’. These surveys suggest that labour is a key component of firms’ costs, but is not the major influence on location decisions. In contrast, surveys which specifically address labour issues confirm that ADIA is influenced (to varying degrees) by labour costs and flexibility.

The Commission’s own survey found that domestic labour market policies had influenced the decisions of about 13 per cent of respondents to undertake offshore operations, about equal with taxation and competition policy. This finding is shared by the ACM, which considered that:

> Despite the importance of market-based factors in location decisions, ACM believes the Industry Commission should not underestimate the importance of labour costs, taxation policies and related government regulations in creating cost-push pressures on Australian firms to move offshore (Sub. 7, p. 3).

Other surveys which have addressed labour-related issues are outlined in Box 6.1.

Factors affecting firms’ sensitivity to labour issues

The information provided to the Commission suggests that the influence of labour issues on investment decisions depends on the characteristics of individual firms, including:

- the nature of the product or service produced;
- the contribution of labour to firms’ total costs; and
- the scope of firms’ offshore presence.

Box 6.1: Labour issues — what the surveys found

McKinsey & Co. (1993) noted that "high labour cost is not the main reason for moving offshore although, for 44 per cent of respondents, it is one factor in the decision to relocate" (p. 32).

The East Asia Analytical Unit (1992) survey on ADIA and exports to Asia identified high relative labour costs (70 per cent of respondents) and restrictive labour market practices (57 per cent) as contributing to some firms' decisions to move offshore.

The State Bank of New South Wales and the Chamber of Manufactures of New South Wales (1993) reported that labour costs were the most significant reason for firms moving, or considering moving, offshore (20 per cent of respondents). Those nominating labour costs as influencing the decision to relocate comprised: 77 per cent of firms moving (or considering moving) offshore; 22 per cent of firms moving to another State; and 21 per cent of firms moving within non-metropolitan New South Wales or to another local area. These results are not surprising since variations in labour costs and employment conditions are likely to be greater between countries than between jurisdictions within Australia.

Edwards and Buckley (1995) found that, while "access to markets" is the prime motive for Australian firms establishing overseas subsidiaries, Malaysian and Thai-based firms cited competitive labour cost as a secondary motive. Moreover, although none of the firms based in the United Kingdom cited cost motivations, some reported that labour costs in the United Kingdom, low by European standards, had influenced their choice of region within the United Kingdom.

The BIE (1995f) found that the prime motivation for ADIA was the pursuit of market opportunities, followed by cost-based factors, including input costs such as materials, energy and labour. It nominated "slow reform to labour markets" as contributing to unnecessarily high local production costs.

The nature of firms' output

Labour-related issues are unlikely to be dominant in the location decisions of firms producing services and/or non-tradeable goods.

For service providers, a local presence is often required to capture and supply markets in other countries — even though some service-based transactions can take place through infrequent contact. And, as noted earlier, manufacturers of low unit value products, such as building materials, frequently find it uneconomic to export because of transport costs. For example, the decision of Pioneer to expand its operations internationally largely reflected substantial transport costs that would make many of its products uncompetitive overseas if exported.

Labour intensities

Labour-intensive firms are obviously the most sensitive to wage and on-cost differences. Given the substantial differences in labour costs among countries, these can be sufficient in their own right to induce a firm to move all or part of its operations offshore.

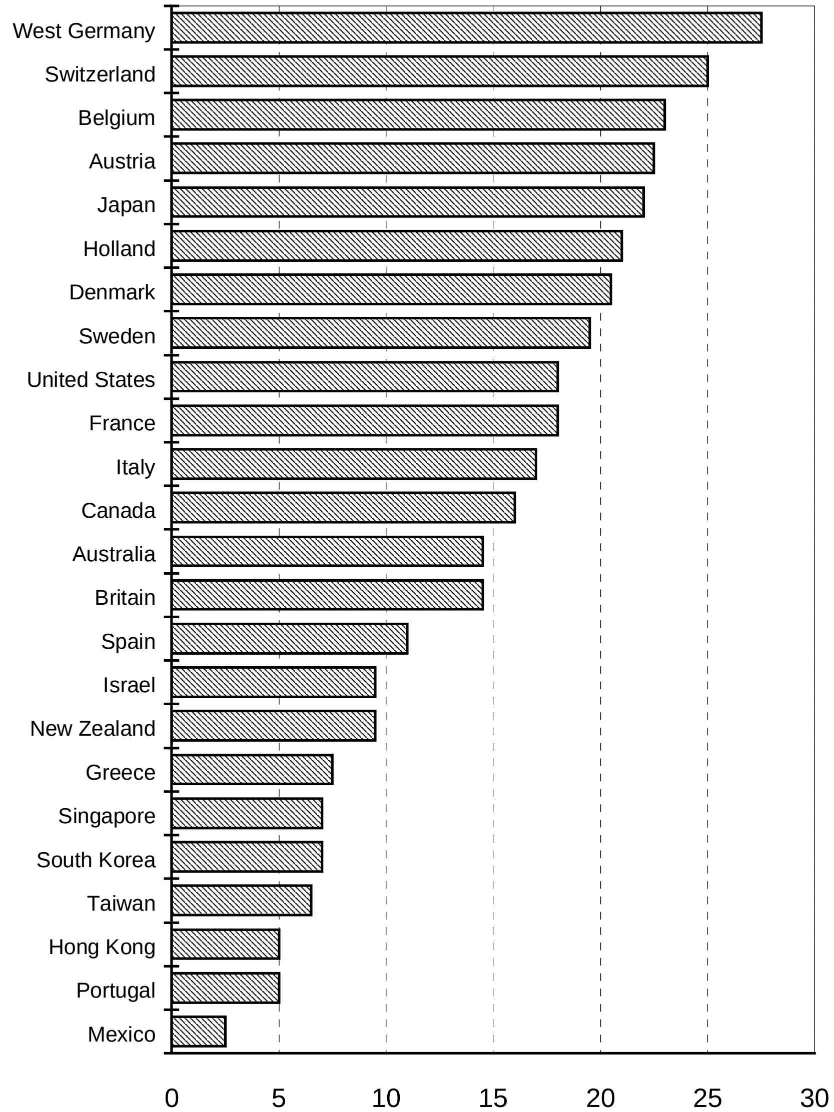
An indication of the extent of variation between countries in *total* labour costs — wages plus on-costs — of manufacturing workers is shown in Figure 6.1. In 1994, labour costs, including non-wage costs such as employers' social security contributions, were highest in West Germany at around US$27 per hour. At the other extreme, costs in Mexico were less than $3 per hour. Participants suggested that labour costs in several Asian countries (for example, China and Vietnam) can be even lower.

A major shortcoming with the data in Figure 6.1 is that they take no account of productivity differences between countries. Differences in productivity can have a substantial impact on unit labour costs. For instance, one study (see Golub, forthcoming) found that, taking into account productivity levels across different nations, average unit labour costs in India and the Philippines were higher than in the United States. Similarly, average unit labour costs in Mexico were estimated at around 70 per cent of that recorded for the United States. Thus, when productivity is taken into account, differences in labour costs are considerably less than the wage differentials shown in Figure 6.1.

Notwithstanding the influence of productivity on unit labour costs, the case of Mark One Apparel (see Box 3.7 in Chapter 3) illustrates that relocation can reduce labour costs, even if productivity levels are substantially lower than in Australia. The study by the Chamber of Manufactures of New South Wales and the State Bank of New South Wales (1993) found that the industry sector with the greatest propensity to relocate offshore is clothing and footwear, one of the most labour-intensive areas of manufacturing. Similarly, the East Asia Analytical Unit noted that some ADIA in South-East Asia reflected the relocation of certain labour-intensive activities to countries with lower labour costs (EAAU 1994).

Although capital-intensive activities tend to be less responsive to differences in labour costs, the way in which labour is used in such activities — its flexibility, rather than direct cost — can be critical. This is especially the case for firms exposed to foreign competition and firms whose labour costs form a large component of 'controllable expenditure'. For example, mining and minerals processing operations are generally capital-intensive, employing labour that is relatively highly skilled and remunerated. In such cases, it is work practices, rather than labour cost levels, which are important for unit labour costs. (For instance, it is typically important to have flexible working arrangements that allow intensive use of equipment and permit productivity-based pay.)

Figure 6.1: Total labour costs for manufacturing workers, 1994 (US$ per hour)



Source: *The Economist*, 9 December 1995, p. 119, based on data from the United States Department of Labour.

Scope of offshore activities

The significance of labour issues is also influenced by the extent of firms' offshore investment experiences. This is largely a reflection of transaction costs which can be high, or even prohibitive, for a firm that has not previously invested offshore. In these circumstances, labour issues alone are unlikely to lead to relocation unless there are very large labour cost differentials. However, firms which already have a presence in two or more countries may be more footloose. For example, the MTIA reported that:

> One of the companies interviewed which already has manufacturing operations in Asia estimated that it could re-locate all domestic manufacture to the Asian region within 6 to 9 months (Sub. 9, p. 19).

In such cases, differences in total labour costs and flexibility can feature more prominently in determining the location of new investment.

Assessing the role of labour in ADIA

For many firms, labour issues, although important, are subordinate to market growth considerations in decisions to invest offshore. This is especially the case for firms producing services and non-tradeables. However, for labour-intensive manufacturing firms, the cost and flexibility of labour can be a critical influence on location.

It is also likely to be the case that firms which already are operating overseas can be more readily influenced by domestic labour market arrangements. There are, of course, 'shades of grey' in between.

Two areas within the purview of governments which participants specifically identified as contributing to offshore investment were direct labour costs (Section 6.2) and labour flexibility (Section 6.3).

6.2 Direct labour costs

Direct labour costs comprise wages and on-costs. Labour on-costs include non-cash remuneration such as superannuation, payroll tax, workers' compensation insurance, leave, employee amenities, uniforms, low-interest finance, housing, electricity, transport, allowances and child care.

For a relatively high-wage country such as Australia, some labour-intensive activities involving low-skill jobs will inevitably move to countries with a comparative labour cost advantage. However, different wage *levels* between countries, particularly at different stages of development, do not contribute to inefficiencies in location decisions. This was recognised by participants. For example, the ACM noted:

> Given our level of economic development and standard of living, we cannot and should not seek to match the low labour cost regimes of ... developing countries (Sub. 7, p. 5).

Moreover, as noted earlier, after accounting for lower average productivity in many less developed economies, the differences in labour costs per unit of output are often significantly reduced. This was commented upon by the MTIA:

> Some companies advised that, while skilled labour was cheaper in Asian countries, Australian productivity levels were higher, which evened out the relative competitiveness levels (Sub. 9, p. 32).

While participants did not submit that average wage levels in Australia were too high, some considered labour on-costs to be unduly onerous. In some instances, relatively high on-costs appear to have 'pushed' Australian-based plants offshore. For example, Box 6.2 outlines the circumstances of one firm which relocated its production of Bendon and Hickory lingerie from Australia to New Zealand on the basis of lower on-costs and greater labour flexibility.

The ACM said:

> ... the difference in our total unit labour costs lies in the fact that our manufacturers face labour on-costs over and above that paid by other countries, including long service leave, annual leave loading, four weeks annual leave, payroll tax and redundancy payments. This places Australian manufacturers at a competitive disadvantage ... (Sub. 7, p. 3).

The Council of Textiles and Fashion Industries noted that 832 textile, clothing, footwear and leather companies, accounting for 82 per cent of the value added, paid payroll taxes in 1992–93. The Council said that these companies were experiencing difficulty in enhancing their competitiveness relative to OECD counterpart industries:

> ... because gains in productivity by Australian operations are, in part, passed on to employees through wage rises which in turn, has increased the burden of PRT [payroll taxes], workers compensation premiums and other labour on-costs (Sub. 46, p. 1).

The MTIA survey reported that labour on-costs in other countries varied significantly. Australian on-costs were considered high relative to Asia, but low compared to some European economies such as Germany — one company advised that on-costs in the Philippines were 15 per cent, but 90 per cent in Germany. Another noted that its on-costs in Australia were 41 per cent compared to 7.5 per cent in Korea (Sub. 9, pp. 32-3).

Some participants suggested means by which on-costs could be reduced. For example, the MTIA sought the replacement of payroll taxes with a consumption tax (and tax credits for export revenue). The Council of Textile and Fashion Industries, concerned about the burden of on-costs on labour-intensive activities such as the production of textiles, clothing and footwear, argued for tax rebates based on the contribution of wages and salaries to a firm's total production costs. The ACM called for export rebates and the Association of Mining and Exploration Companies (AMEC) requested that payroll tax not be applied to non-cash benefits.

Box 6.2: Lingerie business shifted offshore

The Bendon and Hickory lingerie business, owned by Ceramco Corporation, has roughly equivalent sales on either side of the Tasman. In 1994, operations closed in Mornington (on Melbourne's outer fringe) and were relocated to Auckland, New Zealand because of the difference in labour on-costs (about 42 per cent of total labour costs in Australia compared with 14 per cent in New Zealand), and what the company saw as a "more difficult" industrial relations climate in Australia. While wages were slightly higher in Australia, this was said to be of little importance. No other factors were cited as being responsible for moving to New Zealand.

Ceramco said that New Zealand's Employment Contracts Act has greatly improved labour flexibility by bringing employers and employees closer together. It added that the clothing union in New Zealand was "forward-thinking" and assisted in establishing an environment conducive to effective workplace bargaining. It contrasted this with the experience in Australia, where it said the union's main role was to preserve existing award conditions. The New Zealand plant has negotiated a flexibility agreement which provides a 35-45 hour working week to meet fluctuations in product demand. All hours worked are paid as ordinary time at a standard hourly rate (balanced out over the year). Ceramco's view was that it would have been impossible for it to achieve these arrangements in Australia.

Source: Industry visit.

Incidence of on-costs

According to the ABS, about 11 per cent of total labour costs faced by private sector employers are attributable to non-wage factors (see Table 6.1). Superannuation is the most significant on-cost at nearly $1500 per employee. It increased from 4.2 per cent of total labour costs in 1991–92 to 4.9 per cent in 1993–94, reflecting the impact of the superannuation guarantee levy. Total labour on-costs averaged about $3368 per employee in 1993–94.

The ABS covers only 'statutory' on-costs (for example, the superannuation levy and fringe benefits tax imposed by the Commonwealth Government and payroll tax and workers' compensation premiums levied by State governments). Other studies using a broader definition of on-costs have estimated that labour on-costs represent about 30 per cent of hourly labour rates (see, for example, AIDA 1983).

Table 6.1: Labour costs per employee, private sector, 1993–94

Labour cost	*Average cost per employee ($)*	*Proportion of total labour cost (per cent)*
Earnings	26 654	88.8
Superannuation	1 480	4.9
Payroll tax	1 056	3.5
Workers' compensation	566	1.9
Fringe benefits tax	266	0.9
Total	**30 022**	**100.0**

Source: ABS, Cat. No. 6348.0.

When comparing labour on-costs across different locations, firms also consider non-statutory on-costs and differences in hours worked. For example, Bundy Asia Pacific (a subsidiary of Tubemakers), which benchmarked its operations in Australia and New Zealand using a broad definition of on-costs, found on-costs in Australia to be considerably higher than those in New Zealand (see Box 6.3).

The Business Council of Australia noted that, in response to a question in one of its half-yearly surveys:

> ... a number of members said that the relatively much higher labour on-costs in Australia (49% mark up on total direct wage costs) than in New Zealand (21%) made it sensible for them to expand their New Zealand operations and contract their Australian ones, and to supply both markets from the former (Sub. 22, p. 7).

Just as differences in general wage levels are a 'fact of life', so too may be some differences in on-costs between countries, provided that there is a case for their use as revenue measures and they are administered efficiently.

- The rationale for introducing the fringe benefits tax was a widespread incidence of benefits being substituted for cash remuneration. In principle, this form of taxation is equitable and efficient, although there may be scope to reduce compliance costs. (For example, record keeping can be costly for firms.)

- The States and Territories currently have limited access to broad-based taxes, and payroll tax is their major own-source revenue. Without payroll tax, revenue would need to be found by other means (and State taxes are often imposed on business inputs), or government expenditure would need to be substantially reduced.

Box 6.3: Accounting for the non-wage costs of employment

In comparing similar operations in Australia and New Zealand, Bundy Asia Pacific found that in 1991–92:

- the total number of working hours per year, after deducting statutory leave, annual leave and sick leave, was 1824 in New Zealand. After including additional rostered days off and long-service leave provisions, the corresponding figure for Australia was 1668 hours;
- the only additional company expense in New Zealand was workers' compensation, at 2.8 per cent of the base wage. Additional company expenses in Australia (expressed as a percentage of base pay) were: annual leave loading, 1.3 per cent; superannuation, 9.5 per cent; payroll tax, 6.3 per cent; and workers' compensation, 7.1 per cent. Overall, on-costs accounted for about 50 per cent of labour costs in Australia compared with 16 per cent in New Zealand; and
- after accounting for the differences in hours worked and labour on-costs, the Australian worker cost almost 50 per cent more than the New Zealand worker (although the difference was less in trades or skilled areas).

Bundy Asia Pacific commented that, owing to a decline in Australian on-costs and an increase in New Zealand on-costs, the gap has narrowed since the benchmarking exercise. Nevertheless, it considers that the gap remains large.

Similarly, Ajax Fasteners' analysis of its New Zealand and Australian operations found that on-costs in Australia were around 27 per cent, compared with 12-15 per cent in New Zealand. Bendon/Hickory claimed on-costs in Australia were around 42 per cent, compared with 14 per cent in New Zealand. The major reason for these differences is that New Zealand does not have payroll tax or compulsory employer-funded superannuation.

Source: Industry visits.

- There are often conflicting objectives in State workers' compensation schemes: employers want low premiums; injured employees want compensation and rehabilitation; governments want schemes which are fair but do not impose an unreasonable burden on firms; and underwriters want schemes to provide an adequate return on investment. While balancing these objectives, State governments can seek to reduce costs by improving the efficiency of their schemes. For example, Victoria has recently reduced workers' compensation costs after a change of schemes from Workcare to Workcover. Workcare imposed a major cost on employers and failed to achieve its objective of returning a high proportion of injured workers to work.

- Some countries have left superannuation to individuals. To determine the most appropriate means of meeting retirement income needs, many factors must be considered, including a country's demographics and the breadth of its social welfare system.

For non-statutory on-costs (such as staff canteens and certain allowances), enterprise bargaining could potentially provide scope for certain conditions to be traded away for wage increases or other changes in employment conditions of benefit to the employer and employees. One example is incorporating leave bonuses into salaries.

There is also scope within the current system to achieve administrative cost savings by eliminating penalty rates (in exchange for higher base rates). However, the present industrial relations legislation treats some leave-related conditions as ‘community standards’ which cannot be traded, irrespective of the wishes of employers or employees. Similarly, while the Victorian Government’s *Employee Relations Act 1992* means that employees in that State not covered by federal awards are no longer eligible for leave loadings, current Commonwealth legislation gives employees the opportunity to move from State to federal awards, thereby negating the impact of this change.

Some employment conditions are beyond the reach of workplace bargaining — through legislation blocking trade-offs against ‘community standards’ and constraints on firms introducing workplace-oriented conditions at odds with those in occupationally-based awards (see Section 6.3).

In sum, there is only limited scope for employers to reduce the burden of on-costs prescribed by governments. On-cost reductions would require significant changes in government policies on national savings and Commonwealth-State financial relations.

One approach suggested to reduce on-costs to labour-intensive industries involved the provision of tax rebates. However, this would be inefficient in that it addresses the symptoms rather than the causes of the underlying problems. The selective nature of the proposal, and the accompanying difficulty in determining eligibility, are further drawbacks.

The limitations on reducing *total* labour costs underscore the need to improve productivity to reduce unit labour costs. As noted by the ACM:

> As a consequence [of high on-costs], Australian manufacturers need to give greater priority to maximising labour productivity and flexibility if they are to remain competitive (Sub. 7, p. 3).

6.3 Labour flexibility

Reform of federal and State industrial relations systems has increased the scope for firms to implement more productive work practices. Both tiers of government have enacted legislation to introduce enterprise-based bargaining. Consequently, the Australian labour market regulatory framework is evolving from one based on wage bargaining in centralised institutions to one that relies more on negotiation within enterprises. A number of States have introduced less 'restrictive' forms of enterprise bargaining, but Commonwealth legislation allowing workers to move from State to federal awards has limited employers' capacity to take advantage of State systems. Participants' comments in this inquiry centred exclusively on the Commonwealth system.

Changes to the Commonwealth system over the last few years have provided more scope for employees and employers to negotiate mutually advantageous work practices which enhance productivity. For example, the award restructuring process and the introduction of enterprise bargaining have eliminated many of the demarcation problems that plagued workplaces in the past and have enabled some firms to reduce unit costs by operating their equipment more intensively.

It was generally agreed that the new arrangements have resulted in a 'cultural' change, in that both employers and employees are more cognisant of the need for joint initiatives to increase productivity. For example, during industry visits, Robert Bosch (Australia) said that the changes have been helpful — the company has negotiated its fourth enterprise agreement and now operates 24 hours per day, seven days per week. Similarly, Amcor observed that it had a productive relationship with its workforce and that the system had enabled some of its sites to move all employees on to staff.

Nevertheless, many participants considered that, despite the improvements, the system still has elements which inhibit the adoption of more productive work practices and may encourage some firms to look offshore. For example, the ACM, in considering the "inequities that make foreign locations more attractive to Australian firms", said that:

> Changes are required to improve labour market flexibility, lift productivity in our major ports ... and continue overall microeconomic reforms. The consequences of inaction could lead to an acceleration in the flow of Australian companies offshore (Sub. 7, p. 1).

The MTIA's survey of firms involved in offshore operations found that:

> Only 8% of all companies in the sample indicated that present policies were headed in the right direction, and even then these companies felt that the pace of change was too slow. The remaining 92% of companies felt that the present polices as they relate to the award structure and more flexible enterprise agreements are not adequately addressing these problems. When questioned as to what changes are required, the constant theme was greater flexibility ... (Sub. 9, p. 34).

The Minerals Council of Australia provided the following assessment:

> In comparison to other sectors of the Australian economy, labour productivity growth in the mining sector has been strong over the past decade. Even so, genuine labour market reform is still required with changes to the federal industrial

> relations system having not gone far enough. The system is complex and unresponsive and as a result many Australian workplaces are still constrained by restrictive work practices, demarcation disputes, controls on recruitment, industrial action, a legislative bias towards unions, and an award regime of hours, leave, allowances and penalty rates which restricts flexibility and productivity ... The current lack of flexibility does impact on domestic productivity and imposes a constraint on international competitiveness (Sub. 24, p. 45).

CRA said:

> Institutional arrangements (particularly award and union structures) have restricted the capacity of business, unions and tribunals to bring about changes in work practices at a pace sufficient to cope with the demands of the international market (Sub. 13, p. 18).

Similarly, the Chamber of Mines and Energy of Western Australia (Sub. 14, p. 5) commented that “continuing restrictions on labour market flexibility undermine competitiveness”.

The Council of Textile and Fashion Industries said that, while labour cost disadvantages can be reduced by the adoption of flexible production methods, the success of these techniques:

> ... has been severely curtailed by limited flexibility in controlling working hours ... the provisions ... contained in the TCF awards are largely inappropriate to the requirements of companies in seeking to remain competitive in an increasingly integrated global economy (Sub. 32, p. 5).

The Council added that the industry competes with overseas plants which operate almost all year at ordinary hour rates. In Australia, the TCF award requires a 38-hour week with time-and-a-half on Saturdays and double-time on Sundays, with little flexibility. This impedes efficient utilisation of Australia’s plants.

The ACM stressed the importance of improving productivity, but considered that the institutional framework was not helping. It called for changes to the existing arrangements:

> If we are to remain competitive, manufacturers need to achieve world ‘best practice’ standards in labour productivity. To achieve this, ACM recommends that employers be given greater freedom to negotiate employment agreements based on productivity at the enterprise level ... This would not only impact on the pace of firms seeking to locate offshore, but be beneficial to the operation of the Australian economy (Sub. 7, p. 6).

During visits, similar concerns about a lack of flexibility were expressed by Burns Philp, Kraft and Pacific Dunlop, among others. Some firms — for example, Wattyl, Garmond Australia and a number of smaller enterprises represented at the ACCI Round-table discussion in Brisbane — considered that the legislation governing unfair dismissals constrained flexibility, particularly for firms with seasonal variations in production, and deterred job creation.

In addition, some firms whose offshore location decisions are unlikely to be influenced by labour issues, nonetheless informed the Commission that this was an area requiring further reform. For example, Pioneer observed that:

> Australia's labour costs and labour conditions are generally more onerous and costly for industry than those of many neighbour countries (Sub. 4, p. 8).

The South Australian Government argued that greater emphasis should be placed on "the need for systemic reform of the industrial relations system", and that this should:

> ... support a more direct, cooperative relationship between employers and employees as well as greater labour market flexibility. The Government takes the view that significant opportunities now exist under the State's new laws and that the proposed Federal industrial relations reforms will take these opportunities further still.

It added that:

> In this process, labour market reform is targeting work arrangements which will delivery productivity improvements and flexible work practices, which can act to offset higher direct wage costs (Sub. 45, pp. 2-3).

The most prevalent concerns raised by participants in submissions and during discussions centred on: legislation preventing effective adjustment; lack of freedom to negotiate agreements based on productivity; and restrictions on work practices required to meet the demands of the international marketplace. These problems appear to reflect features of the regulatory framework.

The regulatory framework

Under the *Industrial Relations Reform Act 1993*, the federal system provides for two types of enterprise bargaining agreements — Certified Agreements and Enterprise Flexibility Agreements (EFAs). Both agreements are underpinned by the retention of a system of awards that specify minimum rates of pay and conditions of work for most occupations.[1] Consistent with this award structure, unions are generally organised on occupational/industry, rather than enterprise, grounds.

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[1] In 1990, 80 per cent of employees were covered by awards and about 40 per cent belonged to a union. By 1995, union membership had fallen to about 33 per cent of employees.

Certified Agreements are negotiated between unions and employers and ratified by the Industrial Relations Commission (IRC). As a vote of employees is not required, unions can veto a potential agreement if they regard it as disadvantageous to the interests of their members.

EFAs, unlike Certified Agreements, involve no requirement that any union be party to an agreement to which a majority of employees have 'genuinely agreed'. However, if there are union members on site, the employer must notify the relevant union(s) of any negotiations with employees. The union can then elect to become a party to the negotiations. If there are no union members on site, a relevant union (that is, one with carriage for a particular award) can still present arguments to the IRC on why certification should be refused.

A 'no disadvantage' test underpins both forms of agreement. The IRC must be satisfied that the terms and conditions of employment in an agreement do not disadvantage employees when compared with the relevant award. (A greenfields site cannot negotiate an agreement until an interim award has been granted to provide a benchmark for the 'no disadvantage' test.) Some conditions nominated as 'community standards' (for example, leave entitlements) are non-negotiable (see Brereton 1993, p. 2781).

The number of registered agreements is increasing. According to the Department of Industrial Relations, 6300 federal workplace agreements have been formalised since March 1994, and 62 per cent of wage and salary earners covered by federal awards now have formal enterprise agreements. This growth is due to an increase in the number of Certified Agreements: only 185 EFAs had been struck by June 1996. (Given low private sector union membership, the EFA stream could be used by potentially many thousands of workplaces.)

However, in ensuring that workplaces work 'smarter' and link remuneration to productivity, it is the *quality* rather than the number of agreements that is important. DIR (1995), after evaluating agreements reached between March and December 1994, considered that enterprise bargaining appeared to have led to agreements with a "strong focus on productivity and flexibility":

> While very few agreements were 'stand alone' — that is, totally replacing all award provisions — Part VIB agreements as a whole nevertheless took a comprehensive approach to workplace reform, addressing a broad range of provisions, most notably in relation to work organisation, training and hours of work. They were perceived as being comprehensive by many of the managers who had the task of negotiating or implementing them (p. 288).

In a report on enterprise agreements in the first quarter of 1996, the ACCI (1996a) found that "the quality of agreements continues to gradually improve". However, its second quarter report expressed concern about "the slow take up rate of EFA non-union agreements and the way in which many agreements are tied closely to award provisions” (ACCI 1996b).

Reports provided to the Commission by the ACCI (1995d and 1996) indicate that it considers that “it is possible” to strike productivity-enhancing agreements, provided there is support from management, employees and respondent unions. (This is evidenced by the Bosch experience, referred to previously.) However, the ACCI adds that, because the system allows unions to regard the award system as “sacrosanct” and gives primacy to the ‘no disadvantage’ test, such agreements are difficult to achieve (see also ACCI 1994a,b and 1995a,b,c). Indeed, the ACCI (1995c) has spoken of agreements as being:

> ... nothing short of a tribute to employers and unions steering a path through what are extremely complex and litigious agreement procedures (p. 2).

This raises the question of whether agreements which better reflect the conditions which parties agree are most appropriate for their workplaces could be achieved in a simpler and less costly manner.

The alleged complexity of the arrangements is illustrated by Section 170M of the Act, which sets out 18 separate stages in making and ratifying a Certified Agreement. Section 170N outlines 21 steps involved in making an EFA. The OECD (1995d) remarked that the legislation:

> ... still remains very complex and highly prescriptive for both certified agreements and enterprise flexibility agreements. This may mean that negotiating enterprise agreements is time consuming and costly (p. 57).

Apart from the complexity of the arrangements, peak business groups such as the ACCI and the Business Council of Australia have argued that narrow interpretation of the ‘no disadvantage’ test means that agreements can deal only with matters to be read in conjunction with awards, whilst preserving existing award provisions. That is, enterprise agreements are seen as ‘add-ons’ to awards. (Academics have raised similar issues — see, for example, Stewart 1994.)

DIR does not concur with the view that the ‘no disadvantage’ test is a constraint. In a report on enterprise bargaining (DIR 1995), the Department said that no Certified Agreement was rejected for failing that test between March and December 1994. However, DIR did not appear to consider the disincentive effect of the legislation — that is, experienced firms might not submit agreements containing (technical) award breaches because they would regard ratification as unlikely. Moreover, several agreements were varied prior to certification.

A further issue identified by firms relates to the use of occupationally-based awards to underpin enterprise bargaining. In this context, it is argued that awards can be incompatible with the structure of individual workplaces. For example, because most workplaces employ people with a range of skills, work practices that differ by occupation can cut across a workplace's boundary. Many firms are covered by multiple awards.

In sum, there is a widespread perception among participants that the current regulatory framework hampers enterprise bargaining at the workplace level, particularly in view of the fact that unions are able to veto Certified Agreements because they, rather than employees within a workplace, are respondents to awards.

Unions can also intervene in, but not veto, EFAs. For example, under the EFA arrangements, employees may agree to changes in work practices which technically contravene award conditions in exchange for a pay increase. When the agreement goes before the IRC, a relevant union can object on the grounds that the agreement does not conform with the award, possibly leading the IRC to refuse ratification. Intervention from outside a particular workplace can also arise where divisional employers are directed by a head office management which has a broader 'awards-based' industrial relations strategy.

The new Commonwealth Government recently announced that it intended to reshape the industrial relations regulatory framework to support a more direct relationship between employers and employees. It wants a much reduced role for third party intervention, and greater flexibility in the labour market. To this end, it is seeking to introduce a (modified) system of Certified Agreements, and to replace EFAs with a new system of enterprise agreements — Australian Workplace Agreements.

To implement these policies, the Government has introduced its Workplace Relations Bill into the Parliament. In its *Stocktake* report, the Commission identified the key provisions as being those which seek to:

- simplify awards to provide an enforceable safety net of minimum wages and conditions, with benefits beyond these being a matter for agreement at the enterprise or workplace level;
- remove paid-rates awards, and restrictions on the use of particular types of labour and on hours for regular part-time work;
- end the monopoly rights and compulsory membership of industrial organisations, facilitating greater choice for employees in selecting their bargaining agent and ending uninvited third party intervention;

- facilitate agreement-making by employees and employers by providing the choice of informal over-award arrangements, formalised individual agreements (Australian Workplace Agreements) or formalised collective agreements (Certified Agreements), and facilitating access to agreements in a State jurisdiction where the parties so consent;
- restore secondary boycott provisions to the Trade Practices Act; and
- implement a new unfair dismissal scheme (Productivity Commission 1996).

As noted in the *Stocktake* report, progress in these areas would provide “a significant advance in the evolution of an efficient regulatory framework to better facilitate agreements between employees and employers on wages, conditions and work practices” (p. 47).

Offshore locations: The case of New Zealand

Some participants pointed out that, in terms of firms’ scope to change work practices, labour market regulation was even more restrictive in some other countries — certain European nations were noted in this regard. These negative perceptions contrasted with the support for the New Zealand system expressed by firms visited by the Commission in that country (see Appendix A), particularly firms which have operated on both sides of the Tasman.

Historically, Australia and New Zealand have had centralised awards-based industrial relations systems. While both countries have seen a need to move away from such arrangements, the pace and nature of labour market regulatory reform have differed.

The current New Zealand industrial relations system reflects the *Employment Contracts Act 1991* (ECA). The ECA allows employers and employees to determine the terms of their employment relationship with few constraints other than contract law and minimum legislated standards. Employees choose whether to bargain individually or collectively, and whether to represent themselves or appoint a bargaining agent. Employers can determine whether to bargain at the workplace level, at the firm level, or in conjunction with other employers. No employer or employee is covered by a contract to which they are not a party. A statutory minimum code of employment rights (covering dispute resolution, grievances, a minimum wage, holidays, sick leave and safety standards) and the Employment Court and a new Tribunal provide fora for dispute resolution.

The ECA does not afford collective bargaining a privileged position, but nor does it appear to have any inherent bias against it. For instance, Fisher and Paykel (Auckland) told the Commission that its employment contracts were negotiated with the union as this was, in its view, the most effective means of bringing about productivity improvements. Similarly, around sixty per cent of employees at Ajax Fasteners (Wellington) have appointed the union as their workplace bargaining representative.

The ECA only provides a framework for workplace agreements and actions to improve productivity — some managers said that they were still coming to grips with the collaborative nature of the system. However, where the framework of the ECA has been used to advantage by employers and employees, the productivity gains appear to have been pronounced. For example, Bancorp (1993) said:

> Employees now take greater responsibility for decisions concerning their employment contracts, and a closer direct liaison between management and staff has developed. There is more flexibility and opportunity for employers to reward individual efforts of employees and hence greater incentive to improve productivity and initiative (p. 10).

Participants in this inquiry generally shared this view. For example, Comalco told the Commission that the reforms led to a significant investment in its Tiwai Point aluminium smelter, thereby ensuring its viability (see Box 6.4).

Box 6.4: Workplace productivity in New Zealand

Ajax Fasteners

Ajax Fasteners, a producer of nuts and bolts, is based in Wellington, New Zealand. It exports about 25 per cent of its output to Australia, and has a similar operation in Melbourne. In discussions with the Commission, Ajax considered that the ECA, in conjunction with other reforms, had given a “tremendous” boost to its competitiveness and enabled it to reduce its manufacturing costs by 27 per cent.

Ajax is no longer bound by a national award and said that, as a consequence, the workforce at its New Zealand plant is now more flexible because of the removal of previous demarcation constraints. Productivity has increased through the implementation of workplace-oriented work practices and the introduction of productivity-based performance bonuses of up to 20 per cent above the contractual base minima. Many employees have opted to negotiate directly with the company, while sixty per cent of employees have appointed the union as the bargaining agent for the firm’s single collective contract and profit share scheme.

PDL Holdings

In 1991, PDL Holdings, an electrical, electronic and plastics manufacturer, closed its fan and heater-making plant in Melbourne — which had been in operation since 1947 — and relocated to New Zealand. It closed one other manufacturing location, but has retained a wiring and switchgear plant in South Australia and also some distribution activities.

PDL considered that Australia and New Zealand used to have similar manufacturing environments, but New Zealand is now 6-7 years ahead in labour arrangements. It said that enterprise bargaining at PDL’s South Australian plant is a “compromise” compared with what is achievable in New Zealand, where the ECA has facilitated higher productivity, the replacement of shift allowances and penalty rates, and a removal of the “union layer”.

PDL currently sells in Australia and New Zealand, and expects that any gearing up of activity for export to third markets would be from New Zealand.

Comalco New Zealand

In 1991, Comalco faced a decision about whether to commit several hundred million (New Zealand) dollars to upgrading its Tiwai Point aluminium smelter. Despite its age, competitiveness was better than expected. Economic reforms had helped to improve competitiveness: for example, port-related costs had been cut by some 60 per cent, the company tax rate had been reduced and a stable business climate had emerged. During a visit to the company, the Commission was told that the most significant reform was to labour market arrangements, through the ECA.

While the smelter had a relatively good industrial relations record, the ECA was seen as providing the impetus for decisive improvement. In 1991, all employees were offered staff conditions based on individual contracts — the same contracts as were already in place with managers. Initially, the union sought to have itself appointed as a bargaining agent, and 90 per cent of workers agreed. Comalco also wrote to its employees (and spouses) at home, again inviting workers to join the staff. It offered free, independent legal advice to enable employees to compare employment packages. After 6 weeks, all but 4 workers had joined the individual contract system.

Contracts involved: converting to monthly pay; coverage by a staff superannuation scheme; a higher base salary; and cessation of payment for overtime. Employees are rewarded differently on the basis of performance and have rights and obligations under a 'Fair Treatment System', in addition to statutory protection. If improvements to work practices make a job redundant, retraining for another is provided.

Teamwork encouraged employees to contribute their knowledge to problem-solving and designing processes — there are around 30 active improvement teams at the smelter.

These changes are said to have resulted in improvements in almost all aspects of operations, including:

- hours worked per tonne produced have fallen by a third;
- electricity use has fallen;
- in some areas, hours worked to produce anodes have halved; and
- pot room crane break-down hours have fallen by two thirds.

These changes, which occurred without any changes in technology, are indicative of the substantial overall improvement in the performance and competitiveness of the smelter. The Commission was told that the success of the arrangements depends on the commitment and morale of the workforce. If employees are dissatisfied, the cost to Comalco under devolved responsibilities could end up being greater than before.

A decision has now been made to proceed with a NZ$480 million upgrade of the smelter.

The measures adopted by Comalco management and staff in New Zealand to increase productivity have proved difficult to achieve under Australia's system. An EFA for the Boyne Island smelter (Queensland), agreed to by management and employees, has been rejected three times by the IRC. Similarly, according to Comalco, the system has not enabled its operations at Bell Bay (Tasmania) to achieve the flexibility sought.

Source: Industry visits and discussions.

Notwithstanding views that New Zealand's industrial relations system provides scope for mutual agreements on more productive work practices, the Commission found little evidence that it had induced sizeable migration of investment activity across the Tasman.[2]

In many instances this is understandable. For firms engaged in highly labour-intensive and relatively mobile activities (such as clothing and footwear), for example, it is likely that any relocation would be to countries with much lower labour costs (such as China and Indonesia). For other firms, any labour advantages from relocation may be outweighed by other factors. For instance, many firms have signalled the importance in their location decisions of market-based considerations such as proximity to customers. This may favour locating in larger markets (and exporting to smaller markets). These factors are likely to be reinforced by the relatively high cost of trans-Tasman shipping and the significant transaction costs associated with a relocation of activity.

6.4 Summing up

During the course of this inquiry, many firms raised concerns about the impact of regulation on labour costs and flexibility. While for most firms it has not been a primary motivation for locating offshore, it has been important for some.

There will always be countries able to offer lower wages than are paid in Australia. It would be counterproductive for Australian firms to seek to match the lower wages paid in other countries. And there is little scope to reduce significantly the on-cost burden on firms without some fundamental changes in taxation and national savings policies.

The limited potential to improve the 'direct cost' side of the competitiveness equation highlights the necessity to support initiatives that can sustain high wages and firms' competitiveness through productivity growth. Regulatory changes in recent years have provided the scope for employers and employees to negotiate productivity-enhancing changes in working conditions. However, a recurrent theme among participants is that the system remains complex and

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2 Industry support for the arrangements in New Zealand is exemplified in a survey by the American Chamber of Commerce (1995) which focused solely on factors within government control. It found that over 90 per cent of respondents considered that labour market reforms in New Zealand had benefited businesses. This was reinforced by an open-ended question: 'What policy areas of relevance to overseas investment in New Zealand do you feel the current government has performed most favourably on?' Sixteen per cent of respondents nominated a more flexible labour market arising from the Employment Contracts Act — higher than any other nominated area.

costly to operate within, and needs to reflect more closely conditions which employers and employees themselves have agreed are most appropriate for their particular workplaces. A number of participants considered the arrangements in New Zealand to be more conducive to productivity gains.

This inquiry has not provided an opportunity to assess in detail particular aspects of labour regulation, or its effects on particular industries. It has demonstrated, however, that many firms engaged in offshore investment see a need for improvement in labour market flexibility.

The Commission's inquiry thus underlines the need for continuing reforms to facilitate more productive and competitive workplaces. This would reduce the risk of otherwise efficient domestic investment being relocated outside Australia.

7 ENVIRONMENTAL REGULATION

7.1 Introduction

For industry generally, Australia's environmental regulations and regulatory framework do not appear to loom large in decisions to invest offshore. Nevertheless, government environmental requirements are seen by some participants as impeding their operations in Australia and as a factor contributing to decisions to locate offshore. For example, the MTIA noted that:

> On the negative side, environmental regulation was frequently cited as a significant factor, with companies advising that the sheer number and complexity of environmental regulations is a major burden (Sub. 9, p. 28).

A specific issue of concern to a number of participants, including the Minerals Council of Australia, BHP and the MTIA, are two draft papers prepared by the Commonwealth Environment Protection Agency (CEPA) outlining a possible environmental code of conduct to apply to the offshore operations of Australian firms. In essence, the papers propose the development of a voluntary code to encourage Australian firms operating offshore to apply ecologically sustainable development (ESD) principles to their overseas operations, as well as those in Australia. Further concerns raised by participants include the stringency of Australian environmental standards and problems with delays, difficulties and uncertainty in obtaining necessary environmental approvals.

The following section briefly elaborates on some of the participants' more general concerns about environmental regulations. Section 7.3 considers in more detail the proposed code of conduct and its implications.

7.2 Concerns with environmental regulations

A number of issues relating to environmental regulations and approval processes were raised by participants. Some noted that the complexity and stringency of Australian standards were a cause for concern among industry. For example, the MTIA said:

> There are widespread concerns in industry that Australia's approach to environmental legislation is to adopt solutions which are unnecessarily complex and expensive. As stated by one company which reflected a wider industry view ... the Australian government wants to lead the world in environmental initiatives when it would be more appropriate to keep pace with our trading partners in the

> developed world. The costs of environmental regulations on Australian industry reduces their competitiveness against overseas companies not subjected to these regulations.

It added:

> One company, which is a supplier to the oil and gas industry, advises that increasingly tough environmental requirements being imposed on its customers was resulting in a shift in investment by the oil and gas industry to Asia. Thus environmental regulations are indirectly impacting on Australian based suppliers to the oil and gas industry (Sub. 9, p. 29).

Australia's environmental standards are more stringent than those in many other countries, including many developed nations. However, this does not mean that they are inappropriate. The appropriate nature and extent of environmental regulation depends on a number of factors, such as the capacity of the environment to absorb pollutants and the costs of alternative courses of action. To the extent that Australia's environment differs from that of other countries, it is appropriate for our environmental regulations to also differ. The capacity of Australia to pay for environmental reforms also differs from that of other countries, particularly less developed countries.

In determining the level of environmental regulation in Australia, the appropriate benchmark is Australia's own environmental needs and objectives, not the level of regulation applied overseas.

Some participants said that the complex and ambiguous nature of the environmental approvals process required for new developments results in significant delays and uncertainty. Some noted that these delays are often costly to business and resulted in lost opportunities. BHP said:

> An aspect of the length of the approval process is the regulatory system and the number of different bodies from which approval has to be obtained. The multiplicity of organisations from which authority for developments must be obtained is very large in some Australian states, and this greatly adds to the cost and difficulty of undertaking developments (Sub. 15, p. 14).

It noted that:

> BHP discovered, constructed and brought into production a gold mine in Mali in exactly half the time it took us to go through the approval processes for Coronation Hill in Australia (Sub. 15, p. 13).

This criticism, while relevant to the decisions of some firms to locate offshore, also has been echoed in several other Industry Commission inquiries over recent years as being a general concern for industry in Australia.[1]

[1] See, for example, IC 1991 and 1993a,b,c,e.

Complaints about environmental approval processes reflect in part Australia's environmental regulatory framework in which responsibilities are shared among Commonwealth, State, Territory and local governments, each of which has a number of different bodies administering environmental matters. In recent years, some governments have attempted to address this issue by consolidating environmental laws and reducing the number of administrative and other bodies with a role in environmental issues.

Some States have moved towards developing a 'one-stop shop' approach. At the national level, the Intergovernmental Agreement on the Environment aims to facilitate consultation and greater coordination of environmental policies between different levels of government. The Minerals Council of Australia expressed support for the Agreement, but contended that "several of the processes being pursued under the Schedules to the Agreement should be expedited" (Sub. 24, p. 25).

Environmental approval processes must allow time for community scrutiny of proposals. A key policy question is the extent to which such periods can be kept to a minimum, consistent with adequate scrutiny. Given ongoing criticism, there appears to be a case to accelerate efforts to streamline administrative processes.

In responding to the draft report, CEPA said that the Commonwealth Environmental portfolio is currently reviewing environmental legislation and the environmental impact assessment (EIA) process. The review of the EIA process is focusing on developing procedures to provide, among other things, greater certainty and improve the efficiency of the existing Commonwealth process.

Another issue raised by participants, especially mining sector interests, concerns access to land. CRA noted that a number of conservation issues affect access to land, such as World Heritage listing and the National Reserve System. It said that these issues may "contribute to mining companies directing exploration offshore if they cannot access prospective land in Australia" (Sub. 13, p. 17). Similarly, the Association of Mining and Exploration Companies (AMEC) raised a number of environmental issues concerning, for example, international conventions such as World Heritage listing, native title legislation, ESD and Commonwealth forest management. It said:

> Much of [the Association's] growing alarm however, centres on policies introduced and legislation implemented by a number of States, but more particularly by the Commonwealth Government in recent years. The Commonwealth Government's lack of forethought as to the likely economic impact of various environmental and land access policies, coupled with unworkable legislation such as that exemplified by the Native Title Act, clearly demonstrate

> that the creation and maintenance of an environment conducive to continued mineral exploration and development does not rate highly as a Commonwealth Government priority (Sub. 19, p. 4).

The Commission has not examined all conservation issues affecting access to land in detail in this report.[2] However, the issue of native title is considered in more detail in Chapter 8.

7.3 Proposed code of conduct

Nature of the code

Following a direction from the (then) Minister for Environment, a ‘discussion paper’ and a ‘position paper’ were prepared by CEPA proposing the introduction of a code of conduct to address the environmental performance of Australian firms’ offshore operations. In a submission responding to the draft report, CEPA said that these documents had met with opposition from parts of the mining industry and from the resource arms of government, and that the discussion and position papers had not been progressed.

The code is intended to be voluntary and apply to the offshore operations of firms in all sectors of the economy. It would be based on ESD principles and would be sector-specific, with separate codes of practice being developed for each industry sector.

The stated purpose of the code is to:

- promote Australian companies that are operating in an environmentally responsible manner;
- increase community confidence within Australia that Australian companies are operating overseas in an environmentally responsible manner; and
- create an incentive mechanism to encourage those companies which are not operating in an environmentally responsible manner to do so (CEPA 1995b, p. 3).

CEPA proposed a two-stage implementation process. This involved, first, the signing of a Memorandum of Understanding (MOU) (see Box 7.1) by participating companies and, second, the development of industry-specific codes.

In responding to the draft report, CEPA (Sub. 40, p. 3) stated that “this first stage was never represented as, and certainly not intended to be, a government

[2] Some of these issues are discussed in IC (1991).

developed code”. On the other hand, the CEPA papers point to quite extensive government participation. For instance, it was proposed that the signatories to the MOU be individual companies and the Commonwealth Government, and that “all signatories to the Memorandum of Understanding will work with the Australian Government to implement a voluntary code of practice” (CEPA 1995b, p. 8). It is also proposed that Government play a role in developing the industry-specific codes of practice.

> ... codes will be developed by industry in conjunction with government and non-government organisations (p. 6).

What is the motivation for a code?

Under existing legislation, Commonwealth Government agencies involved in offshore projects are required to secure an ‘environmental clearance’ from CEPA if the project is assessed as being likely to have a significant environmental impact. Similar arrangements apply to companies participating in Australian overseas aid projects and to certain companies seeking financial support through the Export Finance Insurance Corporation (although the number falling into this latter category is very small). According to CEPA, the capacity of these organisations to obtain a clearance would be enhanced if they were signatories to a code such as that proposed by CEPA. It said that a code would also improve the efficiency of the present process which, according to CEPA:

> ... is unsatisfactory and impractical for conducting environmental assessments of overseas projects and does not provide the Minister for the Environment much surety when signing off on projects (Sub. 40, p. 3).

However, given the relatively narrow application of these arrangements, this single end-use, of itself, would not justify such a wide-reaching code as that depicted in the papers prepared by CEPA.

Box 7.1: Memorandum of Understanding

We the undersigned undertake to comply with the following principles and apply them as a priority in our business activities.

- Recognise environmental management as an integral and important environment priority by establishing and maintaining environmental policies, programs and practices in each business activity.
- Recognise that environmental decision making must be integrated in all aspects of business planning and operations.
- Recognise that a corporate environmental policy and detailed environmental management plans are essential for integrated environmental management.
- Establish a comprehensive “cradle to grave” environmental management system that sets clear measurable and realistic goals for minimising the impact on the environment.
- Establish environmental performance indicators against which environmental performance/management system can be assessed.
- Progressively improve corporate policies and practices through a process of annual review against rolling environmental performance indicators.
- Accept responsibility for the cost of best practice environmental management, education of employees (including contractors and suppliers), community awareness programs and of damage imposed on others by degradation of the environment, including fair compensation to landholders for deprivation of the use and enjoyment of natural resources.
- Educate, train and motivate employees to conduct their activities in accordance with this memorandum of understanding and the company’s own policies.
- Ensure the participation of all communities directly and indirectly affected by operations in decisions relating to all phases of activity.
- Facilitate the transfer of environmentally sound and appropriate technology and management skills to suppliers and customers.
- Strive to ensure that when negotiating joint venture agreements with foreign governments or private sector organisations, projects and programs accord with the principles set down in the Memorandum of Understanding.
- Comply with all applicable environmental laws, regulations and permits and apply more restrictive internal standards where necessary to conform with this Memorandum of Understanding.
- Recognise that where there are threats of serious or irreversible environmental damage, lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation.
- Recognise that increasingly the best environmental solution is also the best business solution.
- All employees of signatories to this Memorandum of Understanding are expected to understand, promote and assist in the implementation of this policy.
- All signatories to the Memorandum of Understanding will work with the Australian Government to implement a voluntary code of practice.

Source: CEPA 1995b, pp. 7-8.

While it is evident that the code is intended to improve the environmental performance of Australian companies, it is not clear whether or not this is prompted by perceptions that current performance is inadequate. In this context, the CEPA (1995a) discussion paper notes that environmental protection is becoming an important community concern, not only within Australia, but also in relation to the overseas operations of Australian firms. The paper states:

> In a world that is becoming increasingly globalised, this [the implementation of a code] provides Australia with an opportunity, not only to ensure that Australian companies adopt responsible environmental practices, but also to position Australian companies as international leaders in environmental management ... companies with sound environmental reputations will be in the strongest position when competing for projects overseas (p. 1).

There has also been pressure from certain community groups (for example, some environmental and conservation organisations) to introduce a code, particularly following recent adverse publicity surrounding the environmental impacts of some Australian projects overseas.

On a more general level, some environmental groups are concerned that trade and investment liberalisation will encourage a shift in location of highly polluting industries to countries where environmental regulations are less stringent (see Anderson and Drake-Brockman 1995). It is claimed that this could undermine environmental standards in wealthier countries and encourage a competitive 'race to the bottom', reducing environmental standards to the lowest common denominator.

7.4 Is there a role for government?

While a voluntary code would avoid some costs frequently associated with government regulation, the proposal could impose significant costs on government and firms (see later discussion). Consequently, it is imperative that it clearly be demonstrated that there is a problem, or potential problem, which needs to be addressed. If this is the case, it also needs to be demonstrated that the benefits derived from overcoming the problem outweigh the associated costs.

As noted above, CEPA provides little information about the extent of the environmental problems, or potential problems, associated with the offshore operations of Australian companies.

Mainly because of the commercial incentives on firms to act in an environmentally responsible manner, it is possible that the problems (and the benefits from reducing them) are not great. According to BHP:

> International market realities are far more effective [than a code] in driving high standards of environmental performance given the magnitude of investment committed to offshore activities, and the very significant downsides associated with poor performance (Sub. 38, p. 6).

CEPA (1995a) recognises these commercial incentives:

> ... discussions with company executives show an increasing awareness that integrating environmental considerations into operations from the outset has distinct advantages. They say the strength of good environmental reputation is being recognised. Sometimes it is reputation, as much as specific provisions of a proposed bid, that can make or break a company's ranking in bid evaluations (p. 6).

There may be other reasons why firms choose to apply technology incorporating relatively high environmental standards when establishing offshore facilities. For instance, it may be too costly for firms to adapt domestic production processes or capital equipment, or firms may prefer to use only that technology with which they are familiar. For example, as noted earlier, Pacific Dunlop commented that it would not consider using a technology offshore before it was successfully deployed domestically. At the draft report hearing, the Minerals Council of Australia stated that:

> ... the Minerals Council member companies commonly adopt the same management policies, systems, practices and guidelines overseas as they do at home (Transcript, p. 26).

Given the costs associated with retro-fitting plant and equipment, there may also be an incentive for firms to use 'state of the art' equipment to safeguard against the possibility that the host country will increase its environmental standards at a later date. For example, Amcor stated that, as its overseas greenfields investments have a life of about 30 years, it makes good commercial sense to incorporate high environmental standards.

On the other hand, it needs to be recognised that there could be substantial cost advantages to a firm if it could operate with lower environmental standards. In some situations, these benefits could significantly outweigh the advantages of using 'state of the art' plant, particularly if it were unlikely to attract criticism.

A range of other factors also influence the environmental behaviour of Australian companies operating overseas. For instance, they are required to abide by the laws of the host country. Their operations are also influenced by relevant international codes and treaties (see Box 7.2) and, in some cases, by codes of practice developed by industry itself. Some industry sectors — such as the chemical industry — have already developed international codes of practice. The Australian mining industry is in the process of developing a code of practice appropriate to the Australian minerals sector.

Box 7.2: International mechanisms

In 1992, there were about 180 international environmental agreements in existence. In addition, several new legal frameworks are emerging, such as the international convention on desertification. Some of the more significant agreements are noted below.

- The *Rio Declaration on Environment and Development* consists of 27 basic principles designed to guide national and international policies. The principles cover a broad range of issues, including the link between environment and development, the sovereign right of states to exploit their own resources (without damage to others) and the use of economic instruments in environment and development policy.
- *Agenda 21,* which is the main operational product of UNCED, offers a blueprint for future environmental action covering major sustainable development issues, including climate change, marine pollution, deforestation, desertification, human resources and sustainable agriculture. The Agenda aims at integrating environment and development.
- The *Climate Change Convention,* signed by 155 countries, aims at stabilising concentrations of greenhouse gases — carbon dioxide, methane and other heat-trapping gases.
- The *Convention on Biodiversity*, signed by 157 countries, is intended to protect and sustain the earth’s living resources and eco-systems and to share the benefits from the use of genetic resources.

Source: World Bank 1992, pp. 9-10.

These factors reduce the likelihood of firms acting in an environmentally irresponsible manner. Nonetheless, it is possible that, on occasions, environmental damage could occur.

If there were evidence of environmental problems associated with offshore operations, there could be some grounds for government action if the damage caused by individual firms imposed costs on the broader Australian community. This could be the case if environmental standards in the host country were ‘too low’, or were not adequately enforced, such that, by *international standards*, environmental damage would result which is perceived as being indicative of the environmental performance of *all* Australian firms, not just the firm responsible for the damage. This could disadvantage Australian firms wishing to locate in other countries, and could also undermine the environmental credentials (and, hence, sales) of Australian exporters. There are many ‘ifs’ in this scenario. In practice, the greatest repercussions of any such poor company performance are likely to be borne by the company itself. Most companies would factor this into their decisions about environmental standards.

Australia as a nation could be adversely affected if environmental damage had direct consequences for Australia, as well as for the host country. For instance, some allege that discharges from the mining operations at Ok Tedi could pollute parts of Australia's northern waters. Similarly, poor environmental practice by Australian firms could have wider ramifications, such as ozone depletion, which would affect not only Australia, but the rest of the world. Nevertheless, such possibilities are more likely to be the exception than the rule, and in a number of cases are dealt with by specific treaties.

The case for government action to protect Australia from adverse effects stemming from the actions of a small number of 'irresponsible' firms needs to be distinguished from Australia's broader global responsibility. More specifically, as a developed nation, Australia clearly has a role to play in increasing awareness of the importance of environmental issues and, where appropriate, assisting developing nations to overcome environmental problems (for example, by funding environmental improvement projects). However, as this is a collective national responsibility, the costs of pursuing such objectives should be borne by all Australians, not just by firms operating offshore.

In sum, it has not been demonstrated that the environmental performance of Australian firms' operations offshore is resulting, or is likely to result, in costs to the wider Australian community. Nonetheless, if it could be shown that problems do exist, there could be, in certain circumstances, a case for government action. The following section considers issues relating to the effectiveness of one form of action — the code outlined in the papers prepared by CEPA.

7.5 Effects of government action

There are basically three broad areas for consideration in gauging the effect of the proposed code. First, there are possible effects on the competitiveness of Australian firms. Second, there are specific issues about the form of the proposed code and its operation. And, third, there are matters relating to sovereignty.

Effects on the competitiveness of Australian firms

Some industry groups contend that any requirement for the offshore operations of Australian firms to employ environmental standards higher than those required in the host country would make Australian companies bidding for overseas development projects uncompetitive against local firms and other foreign firms. For instance, the MTIA stated:

> From the strong reactions MTIA has received from members, the very idea of introducing a further impost on industry through an enforceable code of practice (for, indeed, to be effective, there would necessarily need to be an enforcement and compliance mechanism) has been rejected as indicating yet further impediments to Australian companies operating competitively overseas (Sub. 18, p. 1).

CEPA (1995a) notes that the cost of a project may appear greater for Australian companies than for those from other countries. It states that:

> Some suggest that as responsible environmental behaviour does come at some cost, it may impact adversely on Australian companies in their bid applications for operations overseas. Others suggest, however, that the experience of most companies integrating environmental considerations from the outset introduces costs that do not make projects uncompetitive. They say that preventing environmental damage is far cheaper than the costs of remediation later on. It is also suggested that good environmental management makes companies more competitive when bidding for operations overseas (p. 2).

It is possible that any decline in the competitiveness of Australian firms could also have implications for the host country. For example, in some instances it could result in the successful bidder being a foreign firm which is less environmentally responsible than Australian firms. In these circumstances, action taken by Australia to improve environmental performance in offshore locations would have the opposite effect.

Any adverse effects associated with a decline in competitiveness may, however, be reduced, or even avoided, if the code is perceived by industry to be purely voluntary. This issue is discussed in the following section.

Specific concerns about the proposed code

There are a number of specific concerns about the form of action proposed by CEPA — that is, a voluntary code requiring signatories to apply Australian standards to their offshore operations. These concerns relate to the voluntary nature of the code, the applicability of Australian standards overseas and administration and compliance costs.

Voluntary nature of the code

A purely voluntary code of conduct overcomes some of the disadvantages associated with regulation. A voluntary code is more flexible than regulation and, accordingly, is easier to update and modify as circumstances change. Also, as voluntary codes are a form of self-regulation established with significant industry input, they may be more acceptable to industry than regulation. Hence, firms may be more inclined to accept the provisions and become signatories to the code.

However, voluntary codes have some significant disadvantages, particularly if they are not supported by a representative cross-section of industry. A major concern is that, because of their voluntary nature, the number of firms prepared to become signatories may be low. If that were the case, the effectiveness of the code would be weakened. Ensuring compliance can also be difficult. For example, it may be difficult to apply meaningful sanctions for breaches of the code.

There is also the potential for a voluntary code administered by government to evolve eventually into 'quasi-regulation', to the extent that government sanctions are introduced (for example, excluding firms that are not signatories from government purchasing processes). This could even occur in the absence of explicit sanctions if companies felt 'obligated' to become signatories because they considered that their failure to do so would lead to a deterioration in their relationship with government. In this context, the Minerals Council of Australia said:

> While the CEPA has proposed a voluntary code, the arrangements proposed give it a degree of coercive flavour (Transcript, p. 25).

The Department of Foreign Affairs and Trade (DFAT) noted that there have already been:

> ... calls by NGO [non-government organisation] groups for a broadly based mandatory code of conduct which would apply to overseas activities of all Australian companies. Some NGO groups have advocated that such a code extend beyond environmental conduct and cover a broad range of offshore activities. Such proposals could involve Australian standards being applied to an extensive range of offshore activities including environmental management, occupational health and safety, workers' rights, human rights and rights of indigenous peoples (Sub. 47, p. 2).

Applicability of Australian standards

A fundamental concern with the proposed code of conduct lies in the suitability of applying Australian standards overseas and the possible ramifications of this.

In responding to the draft report, CEPA stated that the adoption of the proposed code of behaviour would not involve adherence to Australian standards in offshore locations.

> Adoption of codes of behaviour by firms does not mean that particular standards, which are generally taken in the environmental field to be physical emission standards, etc would be adopted (Sub. 40, p. 3).

However, a number of participants — such as Telstra and the Minerals Council of Australia — have interpreted the proposal as involving the application of Australian standards. For example, the Minerals Council of Australia stated:

> ... blanket application of common standards in different countries may be inappropriate and counterproductive and may even lead to suboptimal environmental outcomes (Transcript, p. 26).

The view held by these participants may reflect the wording of the proposed MOU which states the requirement for signatories to:

> Comply with all applicable environmental laws, regulations and permits and apply more restrictive internal standards where necessary to conform with this Memorandum of Understanding (CEPA 1995b, p. 8).

In the Commission's view, it would be inappropriate to apply Australian standards to all offshore projects. There are substantial differences in environmental characteristics among countries (and often regions within countries) and in countries' capacity to accommodate the diverse range of environmental impacts associated with the operations of different industries. Consequently, industry-specific standards developed by Australia may be inappropriate for countries having environmental characteristics significantly different from those of Australia. For example, discharge standards in Australia which take account of local rainfall and water supply considerations may not be applicable to areas in countries overseas which are subject to much higher or lower levels of rainfall. In this context, while supporting a "demonstrated commitment to best practice", the Minerals Council of Australia stated:

> ... sound management systems will ensure high standards of environmental management, with operational detail differing according to different circumstances and environments, including physical, regulatory, social and political (Sub. 24, p. 27).

Furthermore, differing levels of development among countries may mean that, in some circumstances, it is impossible to apply such standards. For example, some countries lack the necessary support schemes or infrastructure — such as sewer systems for trade waste discharges and environmentally sound landfills — to enable the application of more stringent standards. Similarly, in some situations where environmental concerns relate mainly to aesthetic values, developing countries' relatively low capacity to pay could render higher standards inappropriate. For example, the placement of electrical and telephone wires underground is becoming the norm in Australia but, if replicated in some poorer countries, could increase electricity prices and, in effect, deny electricity to many households.

In some instances, it simply may not be possible to apply Australian standards. Projects in which Australian firms have only partial equity (and hence control) provide one example. For instance, Telstra said:

> ... in many of Telstra's offshore activities, the company is partnered by an entity of the foreign government. This would make it very difficult to go beyond *advocating*

> [emphasis added] use of Australian environmental standards where they were more stringent than local regulations, to a situation where Telstra made adherence to Australian practice a condition of its participation in a project (Sub. 33, Attachment B, p. 1).

Administrative and compliance costs

Establishing and maintaining the code could be costly for both Government and companies. For example, the MOU requires participating companies to:

> Accept responsibility for the cost of best practice environmental management, education of employees *(including contractors and suppliers)* [emphasis added].

and to:

> Ensure the participation of all communities directly and indirectly affected by operations in decisions relating to all phases of activity.

and to:

> Facilitate the transfer of environmentally sound and appropriate technology and management skills to suppliers and customers (CEPA 1995b, pp. 7-8).

While some of these requirements are not clearly defined, to the extent that they involve significant interaction with suppliers, customers and local communities in foreign countries, they could involve substantial financial outlays and discourage firms from becoming signatories to the code.

Costs for government could be significant in establishing the code — particularly in assisting with the development of individual industry codes and standards. For instance, substantial inputs were required in the early 1990s by government, industry representatives and other parties involved in the development of the ESD principles. By comparison, once established, recurrent costs could be relatively modest.

Firms may also be reluctant to become signatories to the code given the current concerns with the National Strategy for Ecologically Sustainable Development and its principles which are to form the basis of the code. For example, the AMEC said:

> In its present form, however, the National Strategy does not provide balanced, specific and workable guidelines, which clearly state the criteria to be satisfied with respect to ecologically sustainable development, as it applies to mining projects (Sub. 19, p. 58).

Sovereignty issues

Another possible concern relates to whether government action encouraging Australian firms to comply with Australian requirements is, or could be perceived as, an infringement of the host country's sovereignty. If Australian Government involvement was interpreted as interfering with the internal affairs of other countries, it could damage relations with the host country government and have an adverse impact on business opportunities for Australian firms. For example, the Minerals Council of Australia stated that:

> The Council also believes that developing nations will regard attempts by other nations to dictate policies and outcomes in their sovereign jurisdiction as unnecessary and undesirable (Sub. 24, p. 27).

CEPA (1995b, p.10) agrees that to "impose Australian environmental laws in other countries would undoubtedly infringe the sovereignty of the host nation". However, it contends that its proposal would not "aim to tell other countries what environmental standards they should apply". Consequently, in CEPA's (1995a) view:

> ... a commitment by an Australian operator to be more environmentally responsible than the host country expects does not infringe upon the sovereignty of that nation. Alcoa, for example, makes a commitment in its environment policy to comply with applicable environmental laws in the host country but also makes a commitment to employ more restrictive company standards to conform with its own policy if mere compliance with host country laws will not ensure this. It has been suggested that this policy has not been regarded as an infringement of the sovereignty of any of the countries in which they operate (p. 5).

There is a difference, however, between company policy and action taken by individual companies to adhere to government codes. In practice, whether action taken by the Australian Government to modify the actions of Australian firms' offshore operations is seen as infringing the sovereignty of host nations would most likely depend on the attitude of individual host governments. Such action may well be welcomed by some countries, but may be perceived by others as unwarranted intervention.

There is also a related, but more general, issue on the environment and the rights of developing countries to govern themselves. It is sometimes argued that most developed countries have reached their current standard of living over a prolonged period of time, for the most part having little regard to the environment, and that developing nations should also be afforded time to raise their environmental standards. In this context, it is argued that many developing countries presently cannot afford the tradeoffs between development and the environment that can be made by wealthier nations. From their perspective, the benefits they stand to gain from development (for example, revenue to improve education standards and health infrastructure) may outweigh the gains from having a cleaner environment. On the other hand, it could be argued that it may be better for developing nations to address environmental concerns now, rather than face larger environmental problems and higher costs of remedial action at a later date. This course of action is more likely to be pursued if the necessary information is available to governments about the environmental impacts of new projects.

Overall assessment

There is little evidence to demonstrate that the environmental performance of Australian companies operating offshore is unsatisfactory and imposing costs on other Australian firms. Even if it can be demonstrated that shortcomings exist, the Commission considers that the proposed code would not be an effective means of addressing the problem.

CEPA contended that the development by some Australian industries (such as the mining industry) of codes of conduct to apply to offshore operations suggests that problems do exist. The development of such codes need not be indicative of poor environmental performance. However, even if it is, voluntary codes developed by industry would not be subject to some of the drawbacks associated with a government-sponsored code.

Alternative approach

If it can be demonstrated that there is a problem that *government* needs to address, the question remains as to what would be the most efficient approach.

One alternative which would avoid some of the shortcomings associated with the proposed code, would involve tackling the problem using international fora and codes of practice. A multilateral approach would defuse sovereignty issues and could alleviate concerns that Australian firms would be disadvantaged in overseas markets. A code which is internationally recognised is also likely to be more attractive to firms because, in international markets, such a code would have more status and recognition than an Australian code. As a result, it is likely that a greater number of Australian firms would find it in their commercial interests to accede to the code.

As recognised by CEPA, a disadvantage of an international approach could be the time taken to develop appropriate treaties or codes. However, more than 150 international environmental agreements are already in existence (see Box 7.2 for some examples) and it may be possible to hasten the process by building on existing agreements. One possibility would be to use the International Organisation for Standardisation (ISO) standards in the 14000 series — in particular ISO 14001 — augmented where necessary with other international codes. The ISO 14000 standards, which are currently in the final stages of development, comprise a system of environmental management to help individual companies review and monitor their environmental performance. Box 7.3 briefly outlines the basis of these standards, which already have been accepted by many Australian corporations.

The MTIA said:

> The Interim Standards Series 14000 dealing with environmental management systems gives useful guidelines for businesses which can be effective management tools. There is no need for any additional codes or regulations and the proposal [for a code], in MTIA’s view, runs counter to all other efforts to promote Australian businesses overseas and to encourage the development of a competitive and dynamic economy (Sub. 18, p. 2).

AMEC said that ISO 14000:

> ... provides useful environmental guidelines for mining companies operating overseas ... [and] ... when coupled with the existing stringently policed state and national regulatory regimes, cancels the need for a code of conduct (Sub. 30, p. 10).

Telstra said that it:

> ... is working towards the coordinated development and introduction of an Environmental Management System ... which will ensure a standard of conduct equal to World’s Best Practice (ie: ISO 14000) (Sub. 33, Attachment B, p. 1).

Box: 7.3 Interim Standards Series ISO 14000

The International Organisation for Standardisation (ISO) was formed in 1947 to “facilitate the international co-ordination and unification of industrial standards”. It is a federation of national standards bodies from some 100 countries. The technical work of ISO is carried out by some 2700 technical committees, subcommittees and working groups. In 1993, the ISO Technical Committee on Environmental Management was established to “develop common international standards on a wide range of topics related to environmental management” (CEPA 1995b, p. 4).

These standards, referred to as the ISO 14000 series of standards, provide a model for environmental management. While the standards have not yet been published, five draft standards will shortly be released for public comment. These cover: environment management systems (ISO 14001); environmental auditing (ISO 14010); environmental performance evaluation (ISO 14031); life cycle assessment (ISO 14041); and environmental claims (ISO 14020).

ISO 14001 — environmental management systems — is a voluntary standard based on the principles of ESD. It does not establish performance standards, but requires progressive environmental improvement and will offer companies international recognition through a well known logo.

Following along the lines of ISO 9000, ISO 14000 is a management system benchmark. Management standards are verified by audit and the result is an official certificate. The draft ISO 14000 requires companies to install a system aimed at: setting environmental policy and defining environmental goals; establishing a program to meet the goals and implementing that program in day-to-day operations and emergency situations; measuring performance in achieving those goals and taking action when the targets are not met; and, finally, improvement by repeating the cycle.

ISO 14000 does not replace regulations, legislation and codes of practice (responsible care) with which an organisation has to comply, but aims to provide a system for monitoring, controlling and improving performance regarding those requirements (Fredericks and McCallum 1995).

BHP also said that its businesses are governed by Environmental Management Systems, comprising minimum requirements plus internal arrangements designed to achieve the company’s environmental goals. These systems:

> ... are structured to be consistent with the standard core requirements for environmental management systems as specified by [ISO 14001] (Sub. 38, p. 7).

BHP added that the credibility of such standards in the market depends upon adherence to them being voluntary.

However, some have cautioned that full implementation of an ISO 14000 regime can be expensive and needs to be undertaken with care. The Institution of Engineers said that because ISO 14000 offers a way of benchmarking an enterprise's environmental practices and provides a basis on which to build an appropriate environmental strategy, it can save money and improve environmental outcomes when used appropriately. However, the Institution pointed out that implementation should occur after careful consideration of all of the relevant costs and benefits. The recent Kean (1995) report also expressed some concerns about a lack of understanding, in government and in business, of the uses and limitations of management system standards such as ISO 9000 (quality standards) and ISO 14000.

CEPA (Sub. 40, p.5) said that the ISO 14000 standards, when fully developed, "will be far more detailed and extensive than an Australian code". It said that the code and the standards are "different tools with different objectives, and the two are not competitive". CEPA added that the ISO 14000 standards do not set performance targets, something which it sees as a "serious failure in any alternative mechanism" to a code.

If a multilateral approach involved a new treaty or convention, considerable consultation with industry would be required. In this context, the Commission has heard concerns from industry that the Australian Government has entered into treaties without sufficiently consulting those parties likely to be affected. For example, AMEC said:

> The growing internationalisation of Australian law brought about by the numerous international conventions ratified by successive Commonwealth Governments during the past fifty years, has not only diminished our freedom and sovereignty, but also, in many cases, has precipitated adverse consequences for Australian industry. These trends have generated sufficient concern to give rise to demands that further conventions should not be entered into without due process and debate and that the States must be formally involved in any ratification process undertaken in the future (Sub. 19, p. 42).

These concerns were also raised in a recent inquiry by the Senate Legal and Constitutional References Committee (1995) on the Commonwealth's power to make and implement treaties. The Committee recommended, among other things, that the Government establish a treaties database to provide information to the public on treaties which are under consideration by the Government, and that this information be readily accessible and provided free of charge to the public (p. 9). It further recommended:

> That the Government increase it efforts to identify and consult the groups which may be affected by a treaty which Australia proposes entering into, and groups with expertise on the subject matter of the treaty or its likely application in Australia (p. 11).

DFAT advised that, following consideration of the Committee's report, and of a position paper on *Reform of the Treaties Process* prepared by the States and Territories for the April 1995 Council of Australian Governments, the Government "is committed to widening its consultation at all stages of treaty negotiation". To this end, the Commonwealth and the States agreed in June 1996 to a revised *Principles and Procedures for Commonwealth-State Consultation on Treaties* (COAG 1996, attachment C) and have announced five reforms to the process of treaty-making:

- treaties are to be tabled in Parliament for at least fifteen sitting days before the Government takes binding action;[3]
- tabled treaties will be accompanied by National Interest Analyses;
- a Parliamentary Joint Standing Committee on Treaties has been established (and met for the first time on 17 June);
- a Commonwealth-State Treaties Council will be established (and is scheduled to meet on 15 November); and
- a treaties database is being constructed to make treaty information freely available to the public through the Internet.

The Commonwealth intends to review these reforms after two years (COAG 1996, p. 4).

The Commission supports initiatives to broaden community and intergovernmental consultation prior to the Commonwealth Government entering into international treaties.

[3] The first two such tablings were on 21 May and 18 June.

8 NATIVE TITLE ISSUES

8.1 Introduction

In discussions with mining sector interests, it was commonly observed that the location of investment is determined above all by where the minerals themselves are located, or are thought to be located. It was also emphasised that the extent to which underlying mineral 'prospectivity' is reflected in investment is determined by the conditions of access to the regions concerned; and that land access is greatly influenced by government regulation.[1] For instance, the Minerals Council of Australia said that the "regulatory constraints on land access are factors that decision makers evaluate in determining mineral investments in offshore areas" (Sub. 24, p. 28).

The Commission heard that, in recent years, as land access has become more difficult and uncertain in Australia, it has become less so in other parts of the world with comparable or better prospectivity, such as parts of Asia and Latin America. This combination of circumstances was seen as contributing to a rising proportion of offshore investment by Australian mining companies.

The main source of heightened uncertainty about land access in Australia identified by mining companies is the lack of clarity about native title. That uncertainty was considered to be exacerbated by perceived and actual difficulties with processes under the *Native Title Act 1993* (NTA) introduced, in part, to facilitate the clarification of native title through case-by-case negotiation. The WA Department of Minerals and Energy said:

> While the Department is aware that elements of the petroleum and mineral industries have concerns about a number of issues which may influence decisions to move their business, or an increasing proportion of it, offshore we believe the major issue at this time is the uncertainty, delays and costs arising from the procedures of the Commonwealth Native Title Act 1993 (Sub. 21, p. 1).

These concerns were generally disputed by Aboriginal and Torres Strait Islander representatives. For example, the Aboriginal and Torres Strait Islander Social Justice Commissioner, Michael Dodson, told the Commission that the impacts of the NTA on the mining sector have been "overstated". The Northern Land Council (NLC) said that the "limiting factors are not the Native Title Act

1 The regulation of land access was a major issue in the Commission's report on mining and minerals processing in Australia (IC 1991).

but the unwillingness of governments, mining companies and others to negotiate with native title holders" (Sub. 28, p. 3).

While the NTA raises many questions that go beyond the scope of this inquiry, it is seen by the mining sector as a major factor influencing offshore investment. In addressing this issue, the Commission's approach has been to:

- set out its understanding of how the NTA operates;
- examine whether the impacts of the NTA on the mining sector are likely to be of minor or major economic significance, and of a short-term or long-term duration; and
- set out key areas of concern, options for dealing with them and the implications.

Given the legal uncertainties in this area, the Commission's understanding of the common law applying to native title and of the NTA has drawn, in part, on the views of participants.[2] Participants included the Kimberley Land Council, the NLC, the Aboriginal Legal Service of Western Australia, the Aboriginal Legal Rights Movement, the Aboriginal and Torres Strait Islander Social Justice Commissioner, the Chairman of the Council of Aboriginal Reconciliation, the Association of Mining and Exploration Companies (AMEC), the Chamber of Mines and Energy of Western Australia, and the Minerals Council of Australia. The Commission also consulted the National Native Title Tribunal and officials from the Commonwealth Government and the Governments of South Australia and Western Australia.

8.2 The Native Title Act

The NTA, which was enacted with effect from 1 January 1994, was introduced in response to the High Court's decision in June 1992 in *Mabo and Others v. the State of Queensland (No. 2)* (see Box 8.1).[3] In that decision, the High Court recognised native title as an interest with respect to land that survived the declaration of sovereignty over Australia by the British Crown. The *Mabo (No. 2)* decision raised substantial concerns within many sections of the

[2] Published sources, apart from the legislation itself, include Bartlett 1993, Attorney General's Department 1994, NNTT 1995 and 1996a and ATSIC 1995a.

[3] In enacting the NTA, the Commonwealth Government relied chiefly on its constitutional power to make laws in relation to Aboriginal and Torres Strait Islander peoples. The States and Territories have a similar power, as well as chief legislative responsibility for land use. The legal effect of the NTA is to override State and Territory legislation, particularly that relating to land use, to the extent of any inconsistency.

community. One concern centred around the common law recognition of native title. There was also concern about the questions left unresolved by the High Court — particularly about native title itself (where it still exists, who holds it and its content), the circumstances in which native title is extinguished and the validity of existing property rights over land. These questions arose partly because the High Court, while it set out general principles about native title, dealt only with a particular set of facts.[4] The resolution of these uncertainties could have required costly and extensive litigation in the courts in the absence of legislative action.

The NTA is intended expressly to "do justice to the Mabo decision in protecting native title and to ensure workable, certain, land management" (Keating 1993, p. 2878).

There are also complex social objectives underpinning the Act. The preamble to the NTA indicates a desire to bring about reconciliation with, and self-determination for, Aboriginal and Torres Strait Islander peoples, and to recognise international standards for the "protection of human rights and fundamental freedoms".[5]

The key features of the NTA can be summarised as follows. The Act:

- recognises native title as defined under the common law;
- provides for the validation of 'past acts' (that is, legislative and administrative actions by governments and persons generally before 1 January 1994 which are otherwise invalid because of the existence of native title);
- establishes processes by which native title and compensation can be determined;
- protects native title in relation to 'future acts' (that is, actions by governments and persons which 'affect' native title and which are not past acts) and establishes a process involving a 'right to negotiate' by which future acts, subject to certain exceptions, can proceed;

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4 The case involved a claim by the Meriam people to native title over the Murray Islands.

5 Relevant international instruments include: the *Universal Declaration of Human Rights*; the *International Covenant on Economic and Social and Cultural Rights*; the *International Covenant on Civil and Political Rights*; and the *International Convention on the Elimination of All Forms of Racial Discrimination*.

Box 8.1: The *Mabo (No. 2)* decision

In *Mabo and Others v. The State of Queensland (No. 2) (1992)*, the High Court recognised native title as an interest with respect to land that survived the declaration of sovereignty over Australia by the British Crown. In the leading judgment, Brennan J described native title as comprising "the interests and rights of indigenous inhabitants in land, whether communal, group or individual, possessed under the traditional laws acknowledged by and the traditional customs observed by the indigenous inhabitants" (p. 41).

According to the High Court, the existence and content of native title have their foundation in the traditional laws and customs of the Aboriginal and Torres Strait Islander people in question. Although this implies that native title can only be determined on a case-by-case basis, there are a number of propositions that apply generally:

- claimants must prove that a particular Aboriginal and Torres Strait Islander people has substantially and continuously maintained their connection with the land according to traditional laws and customs;
- native title may include rights of a religious and ceremonial nature and rights to use land for traditional sustenance for hunting, gathering and fishing;
- native title is inalienable other than by surrender to the Crown or according to traditional laws and customs; and
- native title is not frozen as at the time of the declaration of sovereignty over Australia by the British Crown, but can change as traditional laws and customs change as long as they "do not diminish or extinguish the relationship between a particular tribe or other group and particular land" (Deane and Gaudron JJ, p. 83).

The High Court held, however, that extinguishment of native title can occur by the valid exercise of Commonwealth, State and Territory government powers. It can occur without the consent of Aboriginal and Torres Strait Islander peoples or the payment of compensation. There must be a "clear and plain" intention to extinguish native title. In relation to grants of interests in land, this is evidenced by an intention that is inconsistent with the continued enjoyment of native title (for example, freehold title). In the preamble to the NTA, the Commonwealth Government stated that the High Court was of the view that "native title is extinguished by valid government acts that are inconsistent with the continued existence of native title rights and interests, such as the grant of freehold or leasehold estates."

The High Court makes it clear that State and Territory governments are constrained by the Commonwealth's *Racial Discrimination Act 1975* (RDA). This Act makes unlawful the doing of any act that involves a distinction based on race which has the effect of impairing the enjoyment of any human right or fundamental freedom, and provides that a law must not have the effect of denying enjoyment of a right to persons of a particular race to a greater extent than persons of other races. In an earlier consideration of the case, *Mabo and Others v. The State of Queensland (No. 1) (1988)*, the High Court held a 1985 Queensland Act purporting to extinguish native title and to deny a right of compensation to be discriminatory under the RDA and, hence, invalid. In practical terms, this suggests that State and Territory governments can extinguish native title only if compensation is provided.

The High Court held that there are other situations in which extinguishment of native title can occur. For example, it occurs where traditional native title holders have surrendered their native title to the Crown or have lost their connection with the land.

- confers an entitlement to compensation where the 'extinguishment' or impairment of native title has occurred because of validation of past acts or because of future acts;
- establishes a National Native Title Tribunal (NNTT) and confers jurisdiction on the Federal Court in relation to native title matters; and
- establishes a land fund to assist Aboriginal and Torres Strait Islander peoples to acquire and manage land.

Since the passage of the NTA, the legal environment applying to native title has changed considerably. The substantial validity of the NTA was affirmed by the High Court in *Biljabu v. The State of Western Australia (1995)*. There also have been judicial decisions which have affected directly the processes embodied in the Act.[6] Largely in response to some judicial developments, proposed amendments to the NTA were introduced to the House of Representatives in November last year. These proposed amendments have since lapsed.

More change is in prospect. The Commonwealth Government has recently introduced the *Native Title Amendment Bill 1996* and foreshadowed the introduction of further amendments of the NTA. Importantly, the High Court has recently heard — but as yet not decided — the case of *The Wik Peoples v. The State of Queensland and Others (1996)* which involves the legal question of the status of pastoral leases with respect to native title.

The remainder of this section describes four key features of the NTA as they operate at this time. These relate to: the recognition of native title; processes to determine native title; the right to negotiate process; and compensation. A glossary of terms that commonly appear in the NTA is given in Box 8.2.

Recognition of native title

A key feature of the NTA is the statutory endorsement that it gives to the High Court's recognition of native title in *Mabo (No. 2)*. Such recognition is

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6 Key decisions affecting NTA processes have been the High Court's decision in *Brandy v. Human Rights and Equal Opportunity Commission (1995)*, the Federal Court decision of O'Loughlin J in *Northern Territory v. Lane (1995)*, the High Court's decision in *North Ganalanja Aboriginal Corporation and Another for and on behalf of the Waanyi People v. The State of Queensland and Others (1996)*, and the Federal Court decisions of Carr J in *Walley v. The State of Western Australia and Others (1996)* and *Ward v. The State of Western Australia and Another (1996)*.

Box 8.2: A glossary of terms in the Native Title Act

determination of native title	An enforceable decision by the Federal Court about native title.
claimant application	An application to the NNTT or approved body for a determination of native title by a person claiming native title.
non-claimant application	An application to the NNTT or approved body for a determination of native title by a person with an interest in an area potentially affected by native title or by government authorities.
registration	Where claims are placed on the Register of Native Title Claims or where a determination of native title is placed on the National Native Title Register.
acceptance	A decision by the NNTT or approved body as to whether claims or non-claimant applications should be allowed access to mediation by the NNTT or an approved body and proceed towards a determination of native title.
acts affecting native title	An act affects native title if it extinguishes native title rights and interests or if it is otherwise wholly or partly inconsistent with their continued existence, enjoyment or exercise.
extinguishment	The abolition or diminution of native title by, for example, the validation of past acts or the undertaking of future acts.
past act	The making, amendment or repeal of legislation before 1 July 1993 and administrative actions before 1 January 1994 which are otherwise invalid because of the existence of native title. Can extend to some actions taking place after the specified dates where they are linked to actions done in the past (for example, the mere extension or renewal of a lease created before 1 January 1994). May be done by governments or persons.
future act	The making, amendment or repeal of legislation on or after 1 July 1993 and administrative actions after 1 January 1994 which are not past acts and which affect native title. May be done by governments or persons.
right to negotiate	A statutory right given to (registered) claimants and native title holders to negotiate over whether or not future acts, subject to some exceptions, can proceed. These are acts that: relate to mining (including prospecting and exploration); involve compulsory acquisition by governments for a third party; and any other act that is approved by the relevant Commonwealth Minister.

not equivalent to a *grant* of an interest in land and is not dependent on the NTA. Rather, native title is an interest with respect to land that survived the declaration of sovereignty over Australia by the British Crown. As the NLC said, native title "is a pre-existing interest — its existence does not depend on a government grant or statutory recognition" (Sub. 31, p. 7).

The NTA incorporates common law principles on the definition of native title. The main Australian source for these remains the *Mabo (No. 2)* decision. But this decision does not offer a conclusive set of principles (see Box 8.1).

Although there has been much concern in the past about the legal recognition of native title and its definition, this inquiry did not seek to re-examine these issues. Mining sector interests focused their concern on the processes embodied in the NTA to clarify whether native title continues to exist or is extinguished. AMEC said:

> Despite accusations by uninformed commentators, the Australian minerals industry does not reject or oppose the philosophical concept of native title. The real issue ... is the process by which the existence of native title is determined and subsequently recognised (Sub. 19, pp. 7-8).

It is also the position of the Commonwealth Government that the NTA would be retained and amendments would be introduced to "ensure its workability" while respecting the provisions of the *Racial Discrimination Act 1975* (RDA) Act (Williams 1996, p. 3051).

In looking at this issue, therefore, the Commission has taken as given native title as defined in the *Mabo (No. 2)* case and incorporated in the NTA.

Processes to determine native title

According to the NTA, a 'determination' of native title is an enforceable decision about whether native title exists in relation to a particular area and, if it does, who holds it, its content and the nature and extent of any other interest that may affect it.

To obtain such a determination, applications must be made to the NNTT, or to an approved State or Territory body. The States and Territories (apart from South Australia) have not as yet established their own bodies.[7]

Applicants for a determination of native title include: those claiming to hold native title; those with an interest wishing to know whether native title still

[7] With agreement from the Commonwealth Government, South Australia has established its Environment, Resources and Development Court and Supreme Court with jurisdiction to determine native title and deal with future acts.

exists over a particular area; and Commonwealth, State and Territory government authorities. Applications of the first kind are called ‘claimant applications’ (or claims); the others are called ‘non-claimant applications’.[8]

The process for dealing with a claim is depicted in Figure 8.1. The process currently consists of the placement of a claim on the Register of Native Title Claims, acceptance, notification, negotiations and mediation, referral to the Federal Court for determination and placement of the determination on the National Native Title Register.

The process for dealing with non-claimant applications is broadly similar except in two respects — first, non-claimant applications are not placed on the Register of Native Title Claims and, second, if a claim emerges during the period of notification of a non-claimant application, the claim replaces the non-claimant application in so far as the area in question is common to both applications.

Although the Commonwealth Government attempted to confer jurisdiction on the NNTT to make determinations of native title (and compensation), the NNTT’s ability to do so has been undermined by the High Court’s decision in *Brandy v. Human Rights and Equal Opportunity Commission (1995)*.[9]

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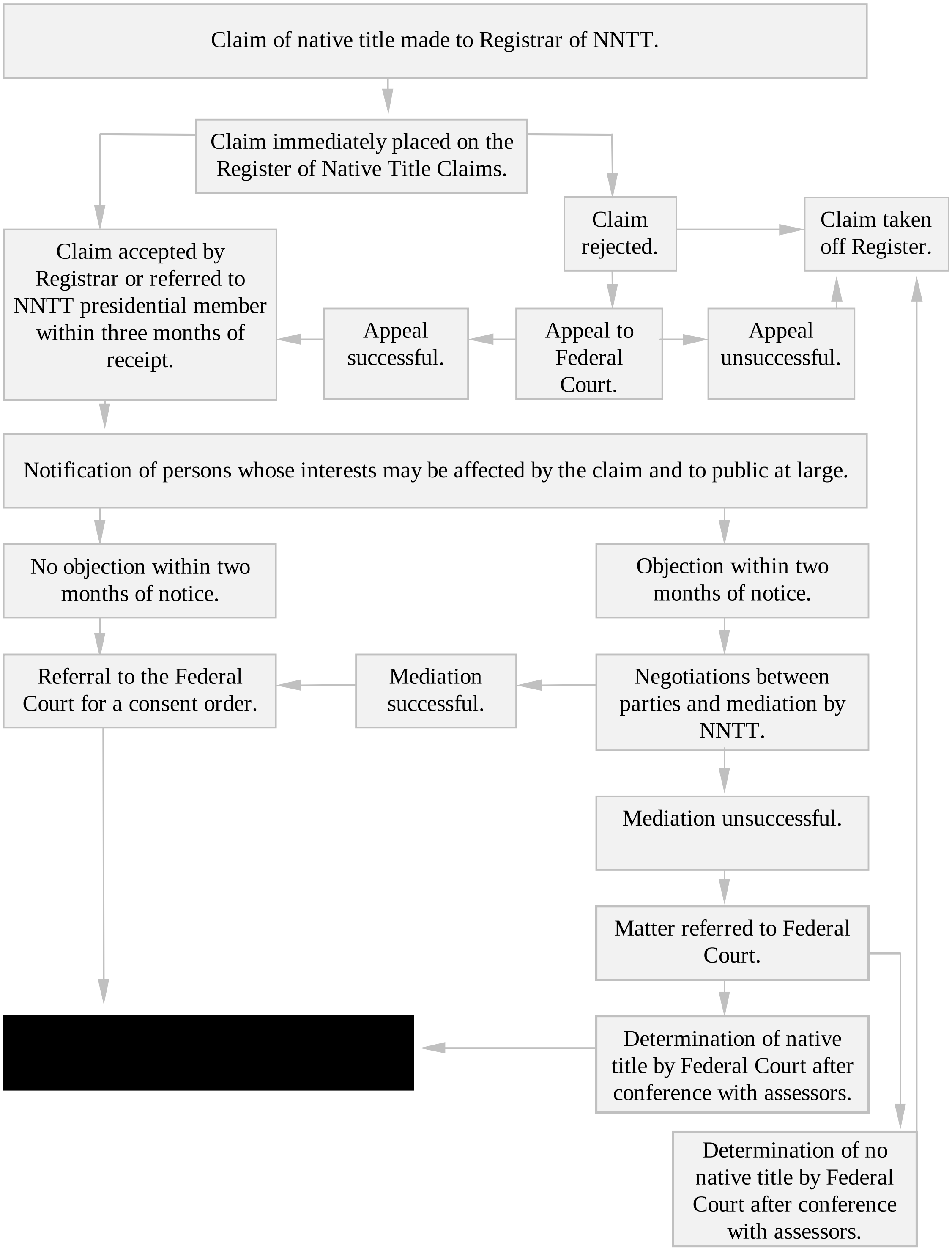
8 A mining company seeking a mineral tenement must rely on the government to bring the non-claimant application.

9 In that case, relevant legislative provisions conferred judicial powers on the Human Rights and Equal Opportunity Commission, which is not a court. The High Court held that, because of limitations relating to the separation of judicial and executive powers under the Constitution, judicial powers can be exercised only by a Commonwealth court and not by the Commission. The legislative provisions which were invalidated by that decision were very similar to provisions contained in the NTA. The practical effect of the *Brandy* decision is to invalidate the ability of the NNTT to make any decisions of a judicial nature, including native title and compensation issues, and to prevent those decisions from being registered in the Federal Court as a judicial order.

Figure 8.1: The process for dealing with claims



Number and status of claims and non-claimant applications

By 2 August 1996, the NNTT had received 386 claims and 98 non-claimant applications since it began administering the NTA (NNTT 1996b).

- Of the 386 claims received, 247 were accepted by the NNTT (of which seven were referred to the Federal Court), seven were rejected, the acceptance of 122 was still under consideration and 10 were withdrawn. There has still not been a determination of native title.
- Of the 98 non-claimant applications received, 50 were accepted, the acceptance of one was still under consideration, 18 were withdrawn, 21 were dismissed or discontinued (largely because a claim had emerged in response) and eight had been determined.

Figure 8.2 shows that the rate of claims lodged with the NNTT has increased sharply over the past year.

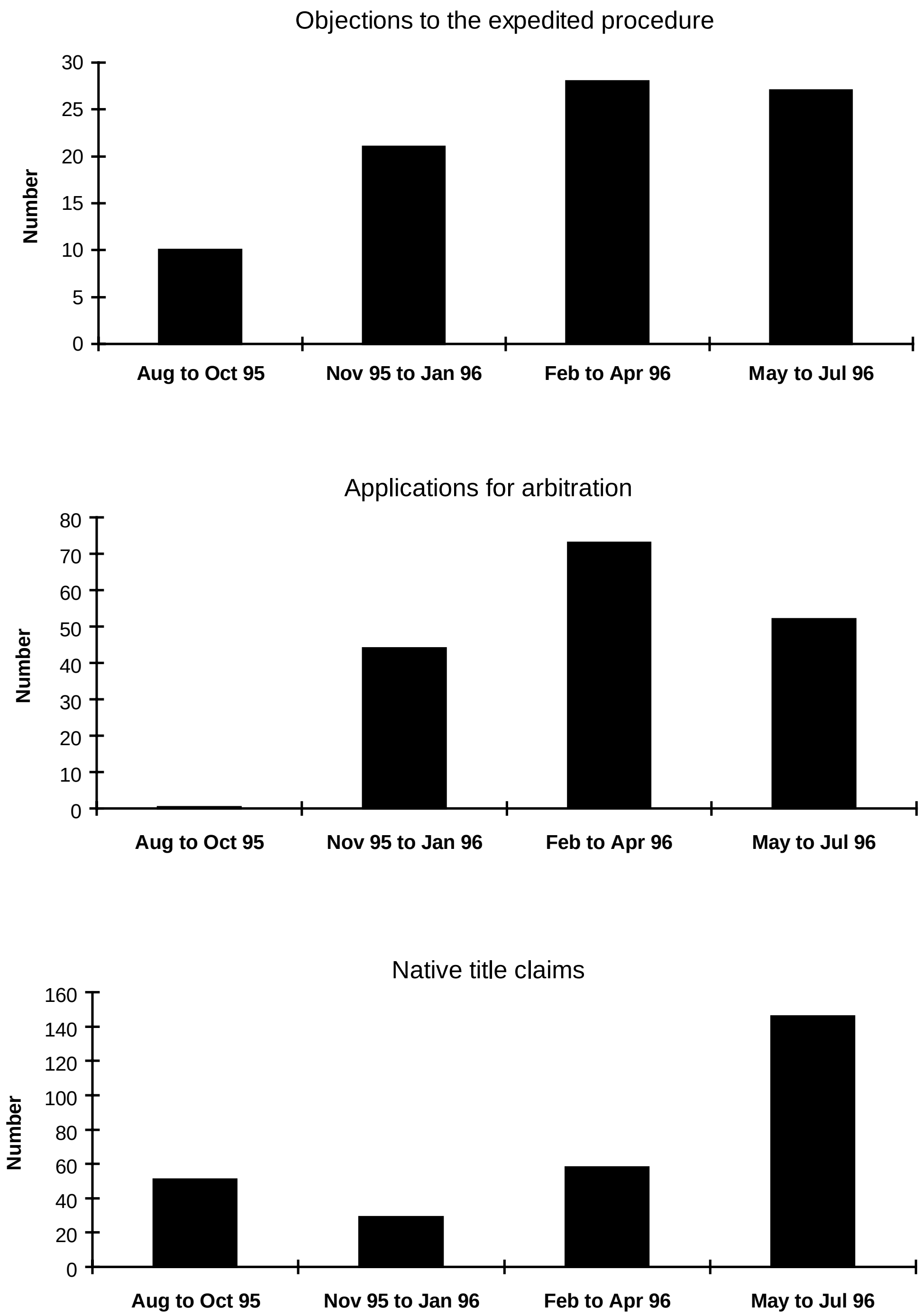
The right to negotiate process

A key feature of the NTA is how it regulates future acts. As a general rule, future acts are permitted if native title holders are treated as if they were holders of ordinary title (for example, freehold title). The NTA makes it clear that native title holders are generally entitled to the same procedural rights (such as the right to be notified) as ordinary title holders.[10]

Future acts are then subjected to a process of statutory ‘clearance’ involving the exercise by registered claimants, as well as by native title holders, of a right to negotiate. (The nature of the right is discussed in greater detail in Section 8.4) This process — as currently administered by the NNTT — is depicted in Figure 8.3 and can operate in parallel with the process for dealing with claims. It consists of notification, negotiation and mediation, and inquiry and determination (or arbitration) by the NNTT. A future act which complies with this process can be then validly done. (Although the States and Territories can establish their own bodies with exclusive jurisdiction to administer the process, only South Australia has done so as yet.)

[10] These rights do not arise if the future act is of low impact (for example, a bee-keeping licence).

Figure 8.2: Applications lodged with the NNTT, 1995–96



Source: NNTT.

Future acts which are subjected to the right to negotiate process are those:

- relating to mining (including prospecting and exploration) such as the grant of a new mineral tenement or the extension of the area or time period to which an existing mineral tenement relates;
- involving compulsory acquisition by governments of native title for the purpose of conferring rights to a third party; and
- approved by the relevant Commonwealth Minister.

There are several ways in which the full right to negotiate process can be avoided or shortened.

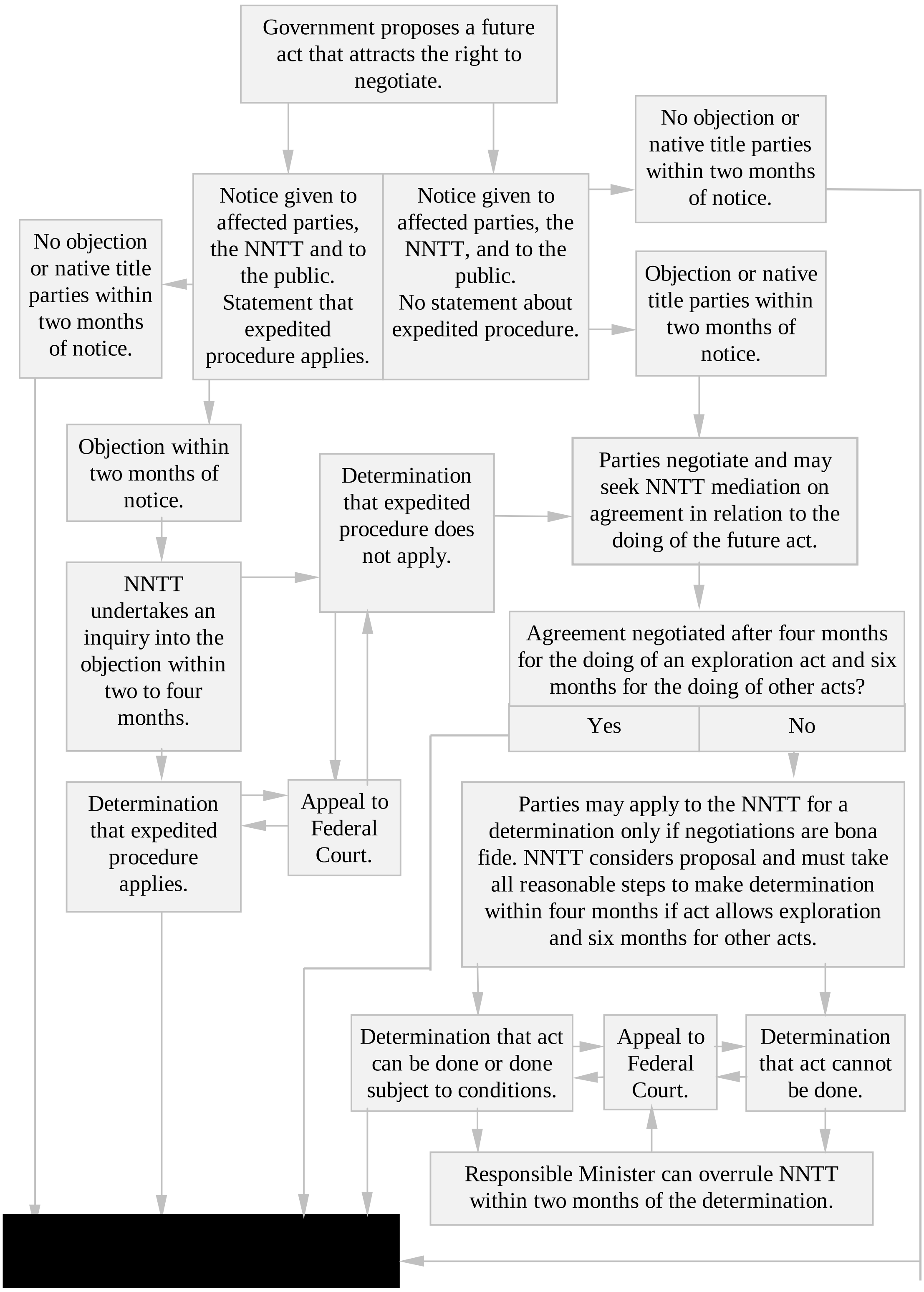
- The relevant Commonwealth Minister can decide, after consultation, that acts with 'minimal effect' on native title can be excluded from the process.
- Governments can invoke an 'expedited procedure', fast-tracking the process, where the future act does not involve major disturbances to the area concerned and does not interfere directly with the community life of, or areas of particular significance to, native title holders (see Figure 8.3). Carr J of the Federal Court decided recently in *Ward v. The State of Western Australia and Another (1996)* that direct interference with community life is not confined to direct "physical" interference (p. 574).
- The right to negotiate does not apply where there is an unopposed non-claimant application. Future acts undertaken by the non-claimant are then protected until native title is determined.

(The potential use of section 21 as a means of bypassing the right to negotiate process is considered in Section 8.4.)

Number and status of future acts notifications and applications

Among the States and Territories, the Western Australian Government is the only one routinely using the right to negotiate process for the grant of mineral tenements. The others have largely avoided the process, often by granting conditional tenements (often described as 'swiss cheese' grants). For example, the South Australian Government issues exploration licences on the basis that they can be exercised over freehold, leasehold and pastoral leasehold land, subject to any native title rights that may be determined (the 'holes' in the cheese).

Figure 8.3: The right to negotiate process



The Western Australian Government began using the right to negotiate process in the NTA after its own legislation was struck down by the High Court in the *Biljabu* case in March 1995. It subjects mineral tenements (formerly granted under invalidated State legislation) to the process only if it assesses that the existence of native title remains a possibility. The WA Department of Minerals and Energy estimated that over 90 per cent of all mineral tenement applications in Western Australia are subjected to the process.

Data from the WA Department of Minerals and Energy show that, between 16 March 1995 and 2 August 1996, about 94 per cent of applications for prospecting and exploration licences (subjected to the expedited procedure) and 23 per cent of applications for mining leases (subjected to the right to negotiate process) were cleared for grant following the notification period (see Table 8.1). The number of mining lease applications subject to negotiation (967) represents a significant increase compared with that (431) at the end of March 1996. Of the mining lease applications subject to negotiation at the end of July 1996, 50 had resulted in agreements.

Table 8.1: Mineral tenement applications subjected to the right to negotiate process or expedited procedure, Western Australia, 16 March 1995 to 2 August 1996

Mineral tenement type	*Referred*	*Through notification period*	*Cleared*	*Objections to expedited procedure*[a]	*Subject to negotiation*
Exploration licences	2 156	1 904	1 737	150	17
Prospecting licences	1 845	1 622	1 568	46	8
Mining leases	1 432	1 253	286	na	967
Other[b]	111	74	50	3	21
Total	5 544	4 853	3 641	199	1 013

a One objection may cover more than one mineral tenement application.

b Covers miscellaneous and retention licences, and general purpose leases.

na Not applicable

Source: WA Department of Minerals and Energy.

Data on applications to the NNTT relating to future acts show that at the end of July 1996 (NNTT 1996b):

- 104 objections to the expedited procedure (some covering more than one mineral tenement application) had been lodged. Thirty four had been determined after inquiry (with 19 objections upheld and 15 objections overturned), nine had been partly heard or reserved for determination, 18 were waiting to be heard, the acceptance of six was still to be considered and 37 had been withdrawn.

- 169 applications for arbitration (involving mining leases) had been lodged. Five had been determined after inquiry (the NNTT determined that all mining leases be granted, three with conditions and two without; no determination involved compensation), 137 were waiting to be heard and 27 had been withdrawn (11 were withdrawn following agreement).

Figure 8.2 shows that in 1996, the rate of objections lodged with the NNTT has stabilised at a higher level, while the rate of applications for arbitration has fallen.

Compensation

Because native title exists under the common law, it must be treated in the same way as any other common law right. There are a number of circumstances under the NTA in which native title holders are specifically entitled to compensation from Commonwealth, State and Territory governments. Generally, these are where:

- a past act extinguishing or impairing native title is validated;
- a future act extinguishes or impairs native title; and
- the RDA requires that compensation be paid for a validated past or future act which affects native title.

In addition, an entitlement to compensation from the Commonwealth Government arises under section 51 (xxxi) of the Constitution where there has been an acquisition of property (which may extinguish native title). This obligation is also imposed through Commonwealth legislation on the Territories.

Claimants and native title holders may also obtain compensation from persons wishing to do a future act. A form of compensation may arise under agreements arising from the right to negotiate process or under section 21 (see Section 8.4).

There may also be compensation arising under the common law from any impermissible future act. This could include costs of rectification or restitution.

Jurisdiction to hear a compensation claim is vested in the NNTT or an approved State or Territory body, the Federal Court, or the High Court. Although the NNTT has jurisdiction, its ability to determine claims for compensation has been undermined by the *Brandy* decision.

The criterion for determining compensation by the courts is generally 'just terms' unless there are other criteria in legislation applying to holders of ordinary title (known as the 'similar compensable interest test'). Broadly, just terms applies to acts where native title has been affected or extinguished or where native title in an 'offshore' area has been impaired, and the similar compensable interest test applies to acts where native title in an 'onshore' area has been impaired.

Although negotiations under the right to negotiate process may include compensation worked out in relation to 'profits made', 'income derived' or 'any thing produced', the NTA prohibits arbitral bodies and the courts from taking this into account when determining conditions under which a future act may proceed.

By 2 August 1996, the NNTT had received and accepted five applications for compensation, but there has been no determination of compensation as yet (NNTT 1996b).

8.3 Impacts on ADIA

Views on the impacts of the NTA on investment, and on ADIA in particular, have tended to be polarised.

Mining sector interests claim that the NTA is having adverse effects. For example, the Minerals Council of Australia said that the NTA "has made access to land in Australia more difficult and costly and introduced uncertainty regarding security of title" (Sub. 24, p. 9).

AMEC said that there is a perception of "elevated investment risk" arising from the NTA and that "a growing number of Australian resource companies are beginning to divert an increasing percentage of their exploration budgets overseas" (Sub. 19, p. 10). The WA Department of Minerals and Energy said:

> [The NTA] has created an environment of uncertainty about delays and costs associated with future development in [Western Australia] and this is now being reflected in companies focussing their attention on alternative opportunities in countries where risks are perceived to be less (Sub. 21, p. 4).

The Commission also was told that small mining companies, not previously active offshore, have begun to undertake investment outside Australia and that exploration for particular mineral resources such as gold and diamonds tended to be affected more than others such as iron ore.

A number of companies, including Western Mining Corporation and Newcrest, said that the NTA is leading to a higher proportion of exploration expenditure in

Australia on existing mineral tenements (‘brownfields’ exploration) rather than in areas for which new tenements are required (‘greenfields’ exploration).

The South Australian Government said that, while it is difficult to be precise about the impacts of uncertainty associated with native title:

> ... it has been estimated that approximately $3-5m of mineral and petroleum exploration expenditure has been deferred in areas facing uncertainty over the status of native title rights. Clearly the lower the investment in exploration, the lower the likelihood of discovering and developing new deposits. However, it is not clear at present that production in South Australia has been curtailed as a direct consequence of native title legislation (Sub. 45, p. 4).

These views were disputed by most Aboriginal and Torres Strait Islander representatives. For example, the Aboriginal and Torres Strait Islander Social Justice Commissioner interpreted the statistics on mineral tenement applications in Western Australia as implying that “miners are not abandoning Australia due to uncertainty about native title and the NTA procedures” (Sub. 26, p. 15). He referred to his most recent report on the NTA in which he attributed additional delays in Western Australia to the State Government. He also observed that offshore investment by mining companies is being channelled into the United States and Canada where there is recognition of a form of native title (1995a, pp. 174-7). (The Commission notes, however, that in those countries, institutional arrangements to deal with native title have been in place for a much longer period of time.) Furthermore, in an earlier report, he stated:

> The problems arising from so-called uncertainty are accentuated in the early stage we are now at in the process of coming to terms with native title. Uncertainty will be reduced through determinations of native title and non-claimant applications and through clarification of the common law (1995b, p. 144).

The NLC considered the globalisation of the mining sector (including increases in its ADIA) had been hastened in recent years by factors such as a more favourable investment climate, easier capital raising and reduced barriers to investment in parts of Latin America, Africa and central Asia. It said:

> In these circumstances, an increase in ADIA by mining houses is to be welcomed ... Insofar as the returns likely to be earned in countries newly opened to overseas mining investment are higher than marginal returns to be expected in Australia, it is to Australia’s benefit to take advantage of the new opportunities. It is not, therefore, necessarily to be regretted that Australian mining houses are investing overseas (Sub. 31, p. 17).

Further, the NLC considered that the specific nature of native title is generally not an issue for mining companies seeking to gain access to land, provided they approach negotiations in a “bona fide fashion” (Sub. 31, p. 7). It pointed to examples such as the St Vidgeon's and Woodcutter's mine agreements, relating to land in the Northern Territory, and the Cape York agreement to support its claim.

Before looking in more detail at the impacts, three general points need to be emphasised.

One is that the social costs and benefits of the NTA extend beyond the potential impacts on ADIA. They include:

- the effects on the well-being of the Aboriginal and Torres Strait Islander peoples and the community at large of having the NTA in place;
- the costs of abandonment and delays of investment in Australia, taking account of income earned from alternative investments and the period of time involved; and
- the legal, administrative, compliance and lobbying costs associated with the NTA.[11]

Secondly, critical to assessment of the impacts of the NTA on ADIA is the choice of the 'counterfactual' case; that is, the alternative arrangements presumed to exist. In some statements about the impacts of the NTA, the implicit comparison is with a 'pre-Mabo' world. The Commission does not consider that this is appropriate, given the acceptance of native title by the Commonwealth Government, the mining sector and the community generally. Rather, the more appropriate counterfactual is a 'post-Mabo' scenario with efficient processes for the recognition and determination of native title that keep uncertainties, transaction costs and delays to a minimum.

The NLC broadly supported the Commission's approach and was of the view that the "idealised" post-Mabo scenario is one that has been reached in the Northern Territory under the *Aboriginal Land Rights (Northern Territory) Act 1976* (ALRA). It said that the Act has operated for 20 years with "negligible effect" on exploration and production and referred to a 1994 study by Manning in support (Sub. 31, pp. 6, 14-15).

However, the Commission has two difficulties with the use of the ALRA as a counterfactual.

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[11] The WA Department of Minerals and Energy estimated that the State's compliance cost (excluding compensation payments) in relation to mineral tenements is about $4.7 million a year, with industry compliance costs being three to four times that amount. A recent study by the Allen Consulting Group (1996) found that, in most cases, direct and indirect costs incurred because of the NTA are "relatively moderate", with direct costs at about $50 000 (p. 3).

- First, the ALRA and the NTA are not strictly comparable, particularly as to the nature of the Aboriginal property rights in question. The ALRA provides for the grant of a form of freehold title (to an Aboriginal Land Trust) as well as a right to veto mineral development. Native title, on the other hand, is not a grant and is variable in nature. Moreover, the NTA provides for a right to negotiate which is not the same as a right of veto.

- Second, the effects of the ALRA are open to dispute. The Commission has found previously that the institutional arrangements for dealing with applications to explore and mine on Aboriginal land in the Northern Territory had not worked well (IC 1991, Vol. 3, p. 58). In the current inquiry, both the Northern Territory Minerals Council and the Minerals Council of Australia pointed to adverse effects of the Act. For example, the Minerals Council of Australia said that the Act has:

  > ... until very recently significantly curtailed the opportunity to explore on aboriginal land (representing 48% of the Northern Territory). As a result the development of mineral deposits on this land tenure has been delayed in the Northern Territory since the passage of the Act (Sub. 24, p. 29).

  On the other hand, in a report to ATSIC, Manning (1994) considered that the "amount and pattern of both exploration expenditure and mine output [in the Northern Territory] are explicable in terms of economic factors (chiefly mineral price trends) and the known and inferred mineral resources of the Territory" and that the Act is likely to have "increased rather than reduced Territory incomes" (pp. 1-2).

A final point to be emphasised is that it is inevitable the NTA would have effects on exploration and production, no matter how cost-effective its processes are. As will be seen below, this is because the Act involves the recognition of a new interest with respect to land that is not well-defined. The NLC said:

> Aboriginal people commonly place valuations on particular parcels of land which diverge widely from those placed by commercial interests, and the recognition of these valuations by recognition of Aboriginal wealth [or native title] will mean that the optimum 'post Mabo' distribution of land use diverges from the optimum 'pre Mabo' pattern (Sub. 31, p. 13).

It follows that it is especially difficult to assess the extent to which costs of the NTA are *higher than necessary* in a post-Mabo world.

The remainder of this section looks at how the NTA affects ADIA, issues in assessing the magnitude of impacts, and available evidence.

How the NTA can affect ADIA

In deciding whether to invest in any exploration or production project, mining companies trade off risks against potential rewards. In relation to exploration, in particular, the risk of commercial failure can be high. For example, AMEC noted that:

> ... from every 1000 conceptual exploration targets investigated by this industry, perhaps only 10 will prove worthy of intensive evaluation. Furthermore, statistics indicate that only one of these final prospects will be developed subsequently as a mine (Sub. 19, p. 11).

Property rights over land have a critical influence on investment risk. This is because access to land, often for a long period of time, is crucial for exploration and production. The Minerals Council of Australia noted:

> The basic requirements for the mineral industry in relation to land access are: ability to explore over the widest possible land area; and assurance that where exploration is permitted, subsequent mineral development will be permitted and the necessary security of title will be granted within reasonable and necessary time frames (Sub. 24, p. 30).

At present, native title is a highly uncertain property right. It is apparent from Section 8.2 that uncertainties extend to who holds it, where it continues to exist, its content and whether it co-exists with or is extinguished by other interests in land such as pastoral leases. (Concerns about the pastoral lease issue are discussed in detail in Section 8.4.)

These uncertainties were inevitable following the *Mabo (No. 2)* decision. The NTA encourages resolution through negotiation rather than litigation. For example, any agreement arising from negotiations pursuant to the NTA process for dealing with claims can form the basis of a native title determination by the Federal Court.

Table 8.2, which classifies the main forms of land tenure in Australia, provides a broad indication of the potential extent of uncertainties about native title (see also Figure 8.4). Land subject to the continued existence of native title may or may not include Crown leasehold (including pastoral leasehold) and public land. Thus, in Western Australia, the continued existence of native title appears uncertain for about 80 per cent of the State. For Queensland, the proportion is about 60 per cent.

Table 8.2: Land tenure in Australia, 1994 (percentage)

	Qld	*NSW*	*Vic*	*SA*	*WA*	*NT*	*Tas*	*ACT*	*Total*
Public land[a]	6.8	10.7	31.8	22.1	43.4	10.2	59.9	62.5	23.0
Private land									
Freehold	36.3	50.6	68.2	16.1	8.1	0.5	40.1	0	20.6
Crown leasehold[b]	54.4	38.5	0	42.5	35.6	49.5	0	37.5	42.1
Aboriginal and Torres Strait Islander land[c]	2.5	0.2	0	19.3	12.9	39.8	0	0	14.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

a Public land covers nature conservation reserves, Aboriginal freehold national parks, other Crown land, vacant Crown land, forestry reserves, water reserves, defence land, mining reserves, and mixed lands.

b The proportion of pastoral leases in Crown leasehold in each State and Territory is estimated to be: 90 per cent (Qld); 79 per cent (NSW); 96 per cent (Vic); 84 per cent (SA); 0 per cent (Tas); 95 per cent (WA); 97 per cent (NT); and 0 per cent (ACT).

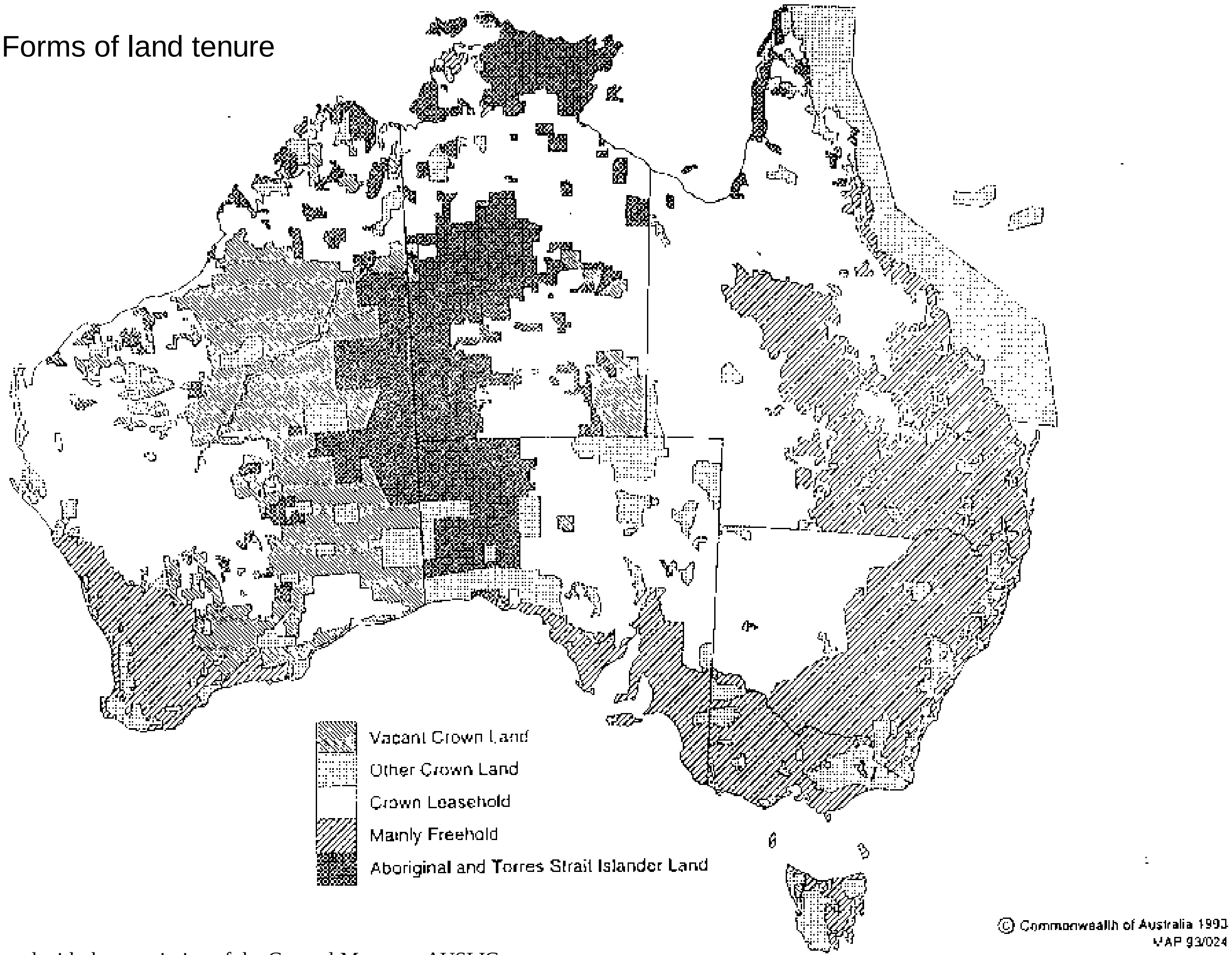
c Aboriginal and Torres Strait Islander land covers freehold, leasehold and reserves.

Sources: AUSLIG 1994a, b.

In principle, property rights must be well-defined as well as legally enforceable in order to promote the kind of incentives that lead to the efficient use of (and investment in) resources such as land. A well-defined property right is one that is allocated to someone, embodies an entitlement to exclusive use of the resource and the benefits from doing so, and is freely transferable.

Because native title is not well-defined, mining companies’ incentives to invest in exploration and production in areas potentially subject to native title are likely to be reduced. Uncertainty as to who has native title, or what it consists of, can raise companies’ perceptions of risk such that the expected reward from investment declines. More importantly, such uncertainties can lead to delays and raise the transactions costs of companies seeking to gain access to land through a negotiated agreement and, hence, add to the cost of investment. It is conceivable that, relative to the value of the investment, associated delays may

Figure 8.4: Forms of land tenure



Note: Reproduced with the permission of the General Manager, AUSLIG.
Source: AUSLIG.

be so long and transaction costs so high that negotiations about access to land may not lead to agreement.[12]

By increasing perceptions of risk and the costs of gaining access to land, uncertainties about native title can have several possible effects on the investment decisions of mining companies. For example, companies can:

- increase exploration and production in areas where all native title is known to have been extinguished;
- increase exploration and production in areas where native title has been determined;
- defer or abandon exploration or production in areas potentially subject to native title claims; and/or
- increase exploration and production overseas.

That being said, it is not possible to generalise about what the most likely response of mining companies would be. In practice, responses are likely to vary, depending, in part, on the characteristics of the company. For example, a small company may face greater constraints than a large company in shifting its activities offshore, or in negotiating with claimants about a domestic investment. The characteristics of the investment can also be important. There is evidence to suggest great variability in the rate of return achievable from individual investments (see AMEC, Sub. 19, p. 3).

The Commission’s view is that recognition of native title and the ensuing uncertainties about land access are likely to have impacts on exploration and production. The question is how significant they are.

[12] This is consistent with a basic result of what is known in economics as the ‘Coase theorem’ which states that efficient allocation of competing resource uses could be achieved through bargaining regardless of the initial assignment of (well-defined) property rights. The result is based on limiting assumptions — such as zero transaction costs, only two parties to each bargain and perfect information. Two refinements of the theorem need to be mentioned. First, the initial assignment of rights may affect the relative wealth of the parties which may, in turn, affect their use of resources. For example, if the parties do not spend their money in identical ways, a shift of wealth between them may alter their demand for resources. This does not undermine, however, the theorem’s result. Second, while transaction costs are never zero in reality, the theorem should hold approximately whenever the total transaction cost is less than the value of the transaction to the parties.

Issues in assessing the magnitude of impacts

Attempts to assess the magnitude of the impacts of the NTA on ADIA and the economy confront some major difficulties.

A fundamental issue, noted previously, is the need to assess the magnitude of impacts relative to an appropriate counterfactual. While is it difficult enough to assess effects resulting from the *Mabo (No. 2)* decision, it is especially difficult to calculate that part of the impacts that is relevant to a post-Mabo benchmark. That is, it is difficult to assess whether the impacts of uncertainties about native title on perceptions of risk and costs of gaining access to land since the passage of the NTA are less or greater compared with alternative regulatory arrangements for dealing with native title.

Other difficulties in assessing the magnitude of impacts relate to isolating the influence of the NTA from other factors that influence the investment decisions of mining companies, and distinguishing short from long-term impacts. These are discussed below.

Relative influence of the NTA

As the Minerals Council of Australia said:

> Decisions to explore in Australia or overseas are based on a comparison of a range of factors including prospectivity, the fiscal and regulatory regimes, risk, and the cost of access to land (Sub. 24, p. 9).

A number of participants noted that the fundamental influence on ADIA is mineral prospectivity. For example, CRA said:

> The prime reason ... for becoming involved in overseas operations is that companies will go to where the best mineral deposits can be found and developed economically (Sub. 13, p. 1).

The liberalisation of overseas regimes governing land access also was seen by many participants as influencing ADIA. The Minerals Council of Australia noted:

> Until recently, many countries had mining and exploration regimes that were not attractive to international investment. But that is all changing and many of these countries are now both being perceived as less risky ... and actively inviting international participation in their minerals industries. Often these countries are not only under-explored but are also highly prospective (Sub. 24, p. 10).

Participants also noted other factors such as taxation and royalty regimes, sovereign and political risk, and infrastructure as relevant influences on ADIA.

Although participants viewed the NTA as only one influence among several on ADIA, the Commission has been told that it is becoming important. This is supported by recent survey evidence.

- In its 1995 survey of exploration activities of member companies, the Minerals Council of Australia noted that the five major areas of concern in relation to exploration in Australia were (in order of importance): indigenous land access; other third party rights affecting the issue of title; Commonwealth regulations; State regulations; and environmental issues (see Sub. 24, p. 30).
- A survey of 18 mining companies (Treadgold 1996) conducted for *Australia's Mining Monthly* (in association with the Export Finance and Insurance Corporation) showed that sovereign risk, land claims and land access were perceived as very important factors compared with other factors such as labour relations, infrastructure and 'green' and 'red' tape (see Table 8.3). It also showed that, when all factors are weighted for their relative importance and combined for each of 15 countries, Australia ranked third as a preferred location for investment in the mining sector, dropping from a ranking of first in the previous year. It considered that:

  > Australia's decline from first to third ... was caused almost totally by increasing concerns about land claims — the Mabo factor. If it were not for Mabo, Australia might well have improved its ranking with a better result in the categories of red tape and civil unrest (p. 22).

- As part of a survey undertaken for this inquiry of the impacts of the NTA on ADIA, seven of 12 major mining companies ranked improved access overseas as the most important factor for them; six companies ranked the NTA as second in importance; and seven companies ranked domestic environmental regulation as third.[13]

Short-term versus long-term impacts

Another issue in assessing the magnitude of impacts of the NTA is whether the impacts are likely to be short-lived or to persist over the long term.

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[13] The combined exploration expenditure of these companies in Australia and overseas in 1994–95 was about $800 million, or about 40 per cent of exploration expenditure recorded by the ABS for that year.

Table 8.3: Risk assessment of investing in the mining sector in selected countries, February 1996

	Investment risk factors (degree of importance — 0 is unimportant, 5 is most important)										
	Sovereign risk	*Land access*	*Green tape*	*Land claims*	*Red tape*	*Social risk*	*Infra-structure*	*Civil unrest*	*Natural disasters*	*Labour relations*	*Weighted totals*
	4	4	3	4	3	3	2	3	1	2	
	Risk levels associated with the factors for various countries (degree of risk — 0 is no risk, 5 is maximum risk)										
Chile (2)	1	1	1	1	1.5	1	2	1	2	2	7.1
Argentina (3)	3	2	2	1	2	2	3	2	1	2	11.8
Australia (1)	1	3	3	4	1.5	2	1	0.5	1	2	12
Canada (5)	1	3	3.5	3	2	2	1	1	1	2	12.1
Indonesia (6)	2	2	2	2	2.5	2	3	2	2	2	12.3
Zimbabwe (8)	2	2	2	2	3	2.5	2	2	1	2	12.3
Peru (9)	3	2	1.5	2	2	2	3	3	2	2	13.1
USA (4)	1	3	4	3	3	3	1	1	1	1	13.2
Mexico (7)	3	2	2	2	2	2	3	3	2	2	13.4
Philippines (12)	2	3	1.5	2	3	2	3	3	3	2	13.9
S. Africa (10)	3	2	2	3	3	2	2	3	1	3	14.6
Vietnam (11)	4	2.5	1.5	2	4	2	3	2	1	2	14.7
China (14)	4	3	1	1	4	2.5	4	2	2	2	14.9
Russia (13)	4	3.5	2	2	4	2	4	2.5	2	2	16.7
PNG (15)	4	3	3	4	3	3	4	4	3	2	19.6

Note: Number in brackets is the ranking from the survey in 1995.
Source: Treadgold 1996, p. 23.

Several participants from the mining sector commented on this issue. The WA Department of Minerals and Energy said:

> If the current uncertainties continue and the backlog of unresolved negotiations continue to build up, industry will move to "greener pastures" and past experience shows that when such a shift occurs, it may take many years to reverse. The mid to long-term effect of the current arrangements will be reduced exploration investment and fewer mineral and petroleum discoveries leading to reduced production, exports, employment, royalties and general economic activity especially in Western Australia (Sub. 21, p. 5).

The Minerals Council of Australia said that, while "the impact of the Act is being felt on exploration activity in Australia already, its full impact will not become evident for several years" (Sub. 24, p. 9).

Conclusive judgments about the duration of impacts are difficult to make given that little time has elapsed since the passage of the NTA. It has been in operation in Western Australia for about one and a half years and in the other States and Territories for about two and a half years.

Whether impacts are short or long-term depends in part on whether the uncertainties about native title are of a short or long-term duration. A major uncertainty about native title is the status of pastoral leases — whether they extinguish or co-exist with native title. The Commission has been told that the courts might take at least five years to resolve this issue one way or another. If the courts determined that pastoral leases did not extinguish native title, then it would take a much longer time for uncertainties about native title to diminish. Indeed, it could take 20 years or more to resolve them through case-by-case determination. (This is discussed in greater detail in Section 8.4.)

Another consideration in assessing whether impacts are likely to be short or long-term is the likely nature of mining companies' responses to the uncertainties about native title.

If the most likely response of mining companies is to defer exploration in areas potentially subject to native title until native title is determined, adverse effects on exploration and production may become essentially short-term, and be reversed or mitigated over the longer term.

Alternatively, if the most likely response is to increase exploration and production overseas, or in areas of Australia where native title is known to have been extinguished or where there are existing tenements, adverse impacts on exploration and production may be less apparent in the short term, but may be more substantial in the long term as a less than optimal sequence and location of investment is chosen. There is a possibility that, even where uncertainties about native title recede over time, adverse effects may be protracted.

Available evidence on impacts

The conceptual difficulties described above are compounded, at this stage, by the limited evidence available on the impacts of the NTA on ADIA and the economy. There are three broad sources of evidence: surveys of mining companies' responses to the NTA; data on exploration expenditure and the extent of delays in the granting of mineral tenements; and the results of economy-wide modelling.

Surveys of mining company responses to the NTA

Although the Commission has been told that the NTA is now becoming an important influence on ADIA, few studies to date have systematically assessed the investment responses of mining companies to the NTA. One exception is a recent study by the Allen Consulting Group (1996) for the Chamber of Mines and Energy of Western Australia, based on a survey of 30 companies, of the impacts of the NTA on Western Australia. Although the study covered a range of matters — for example, companies' experiences with Native Title Representative Bodies (NTRBs), Aboriginal communities and NTA processes for dealing with claims and future acts — it made the following observations about how investment decisions are being affected by the NTA.

- Many of the companies surveyed were taking a "native title neutral approach" to gaining access to land.

  > Key sections of the Western Australian mining industry appear to be in the process of adopting a pragmatic attitude to managing the actual or potential impact of the [NTA] on their enterprises' ability to gain access to land. Many of those enterprises whose existing or proposed projects are affected by accepted or expected native title claims are, with some significant exceptions, considering the establishment of agreements with current or likely native title claimants to enable the timely granting of mineral tenements (p. 6).

- Companies which had entered into agreements said their actions were caused by commercial pressures.
- Companies were feeling their way cautiously in negotiations. There were concerns that "precedent setting, Aboriginal financial expectations and inexperience on both sides in reaching such agreements have hampered the process" (p. 10).
- None of the companies indicated that projects had been delayed significantly or cancelled because of native title issues. Applications for mineral tenements are at a rate similar to that achieved prior to the NTA's application in Western Australia. (This issue is taken up below.)

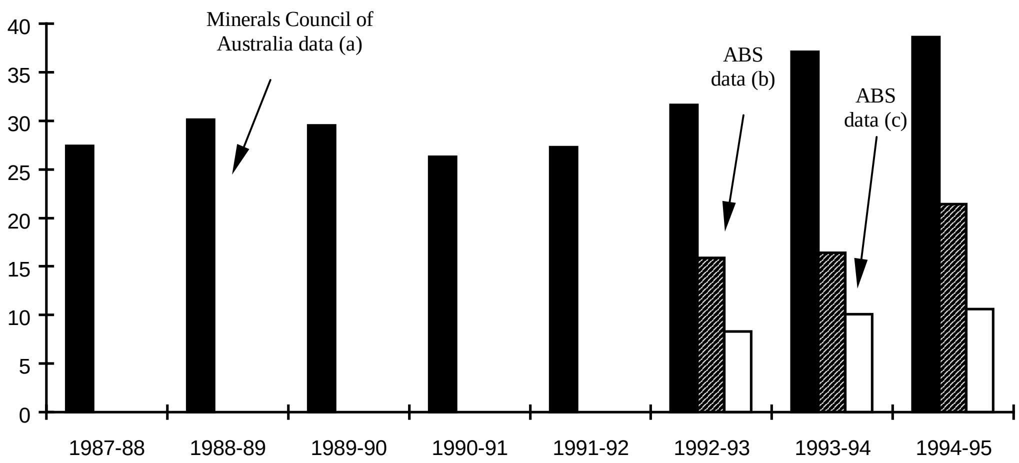
The study provides no indication of the extent to which exploration and production are currently being diverted from land potentially subject to native title or of mining companies' longer-term perceptions of investment opportunities within Australia or overseas. In relation to the former, relevant available data are of some value.

Exploration expenditure

An indication of impacts of the NTA may be given by trends in the level and pattern of exploration expenditure in Australia and overseas.

The available data indicate that the overseas share of exploration expenditure is increasing, particularly since the *Mabo (No. 2)* decision. This is shown in Figure 8.5 which presents ABS and Minerals Council of Australia data.

Figure 8.5: Overseas shares in exploration expenditure, 1987–88 to 1994–95 (percentage)



a Covers minerals exploration expenditure only. The data are drawn from surveys of a constant group of mining companies since 1987–88.

b Covers minerals and petroleum exploration expenditure. (The ABS began collecting data on overseas exploration expenditure in 1992–93.)

c Covers mineral exploration expenditure only.

Sources: ABS, Cat. No. 8412.0 (various years); Minerals Council of Australia, Sub. 24, p. 14.

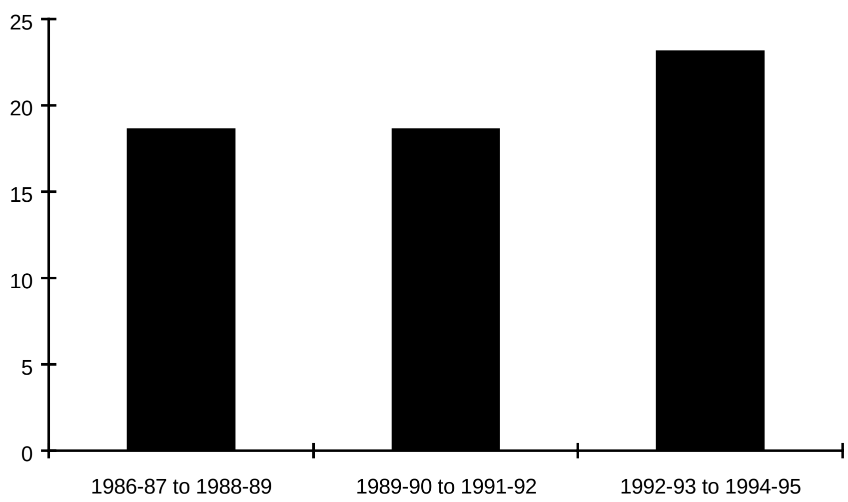
However, as noted earlier, it is not possible to attribute trends in the shares of overseas expenditure on exploration entirely to the NTA as other factors may be important. The NLC argued:

> The actual increase in ADIA by Australian mining firms, and the reduction in metals exploration expenditure in Australia as a proportion of world expenditure, do not constitute evidence that the NTA has had any effect, since there are good

world market and company strategic reasons why they should take place (Sub. 31, pp. 19-20).

While trends in overseas exploration expenditure can be detected, it is more difficult to identify trends in brownfields or greenfields exploration in Australia (another potential indicator of the impacts of the NTA).[14] It appears that the average percentage share of exploration on production leases has increased significantly since the *Mabo (No. 2)* decision (see Figure 8.6). But there are no trend data on expenditure on existing exploration tenements, as distinct from newly granted tenements.

Figure 8.6: Average share of mineral exploration expenditure on production leases (percentage)



Source: ABS, Cat. No. 8412.0 (various issues).

Extent of delays in the granting of mineral tenements

Another indication of impacts of the NTA may be provided by the rate at which applications for mineral tenements are proceeding to a grant under the right to negotiate process.

Data from the WA Department of Minerals and Energy show that the difference between the average weekly rate of applications for mineral tenements received

[14] A survey by the Minerals Council of Australia found that 47 per cent of exploration spending in Australia in 1994–95 was on "existing mining leases" (essentially existing production leases) and 53 per cent was on greenfield sites. The mining companies surveyed accounted for over 67 per cent of total mineral exploration in Australia as reported to the ABS in 1994–95, and for the bulk of the exploration expenditure overseas.

and that of tenements granted has widened since the State Government began implementing the right to negotiate process after the High Court decision in the *Biljabu* case in March 1995. While the weekly rates of applications received before and after the *Biljabu* decision are comparable (98 and 96, respectively), the weekly rates of grants differ significantly (81 and 46, respectively).

Part of the difference between applications received and grants made since the *Biljabu* decision is attributable to a backlog that occurred when the WA Department of Minerals and Energy stopped processing mineral tenement applications for one month after the decision.[15]

The right to negotiate process itself is also contributing to the variation. Table 8.1 in the previous section shows that about 77 per cent of applications for mining leases were not being cleared in the minimum time possible and were thus subject to negotiations. If government participation in negotiations is bona fide, the parties can seek NNTT arbitration after six months. Otherwise, further delays to the grant of mining leases could be experienced. (Further discussion on the sources of these delays is presented in Section 8.4.) In contrast, only a small percentage of prospecting and exploration licences was not being cleared in the minimum time possible.

These data suggest that, at present, the magnitude of impacts of the NTA may be more significant for production than for prospecting or exploration.

CIE report (1994)

It is clear from the above discussion that, because of conceptual difficulties, limited data and the relatively short operation of the NTA, it is not possible at this stage to provide an accurate assessment of the impacts of the NTA on ADIA and on the economy.

The CIE (1994) attempted to quantify the impacts of the NTA using an economy-wide model (see Box 8.3). It assumed that the NTA would lead to a 5 per cent drop in production in Western Australia. In turn, it estimated that this would lead to a decrease in GDP of $346 million in 1992–93 prices (that is, about 0.1 per cent of total GDP).

[15] Until mid-April 1995, the WA Department of Minerals and Energy did not process any mineral tenement applications. After that time, it commenced referrals of tenement applications under the right to negotiate process. The notification period on the first batch of applications concluded on 16 July 1995.

Box 8.3: CIE modelling of the impacts of the NTA on Western Australia

In its report on the impact of the NTA on Western Australia, the CIE (1994) modelled the impacts of the NTA using Monash-MR, an economy-wide model.

It considered that it was likely that:

- exploration and production would tend to shift to areas where there was greater certainty of title and therefore less risk;
- exploration and new mines, particularly those with short lead times, would be delayed or shelved, or applications would not go ahead; and
- although production from existing mines would be largely unaffected in the short to medium term, there may be some impact in the longer term as renewals of mining leases are subject to the NTA processes.

The CIE concluded that new discoveries which would have renewed the stock of mines would be affected adversely with a consequent reduction in production. Accordingly, it considered that production in Western Australia would decline permanently in value in five to six years time by 5 per cent compared with the situation where the previous Western Australian legislation was operational. The estimated financial effect of this decline (in 1992–93 prices) was a fall in: real national GDP of $346 million; real national consumption of $62 million; and Australian mining production of $307 million.

Source: CIE 1994.

However, this estimate should be viewed with some caution because of, for example, the implicit pre-Mabo counterfactual used and the non-inclusion of foreign income arising from any investment diverted overseas. The NLC said that the assumption about the drop in production would “now be seen as excessive even by mining industry interests” (Sub. 31, p. 20).

While it is clearly very difficult at this stage to estimate the production effects of the NTA, the CIE’s modelling work indicates that, for every one per cent drop in Western Australian production, GDP would decline by approximately $70 million in 1992–93 prices (or about 0.02 per cent).

Summing up

It is to be expected that the recognition of native title and the resulting uncertainties about land access would have impacts on mineral exploration and production.

However, for three main reasons, it is very difficult to assess the size of the effects and the extent to which they are greater than necessary. First, the recognition of native title has been only a relatively recent occurrence. Second, there are conceptual problems. For example, it is difficult to isolate the NTA from other factors that influence ADIA by mining companies, and to determine the duration of the effects. And third, the available data are limited, both in terms of the level of aggregation and the time period covered. Such data as are available suggest that, while the proportion of exploration expenditure offshore has been rising, especially since the *Mabo (No. 2)* decision, the demand for exploration tenements in Australia continues at a high rate.

What seems clear is that the longer it takes for uncertainties about native title to be resolved, the more costly they are likely to be. It is therefore imperative that any problem areas in the NTA, particularly those which may exacerbate uncertainties about native title, be dealt with as soon as possible.

8.4 Major areas of concern relating to the Native Title Act

Although the NTA was introduced to facilitate clarification of native title, mining sector interests and others raised concerns about a number of important aspects of the NTA. The concerns which are the focus of this section are:

- the lack of a clarity about native title;
- the lack of clear law on the status of pastoral leases in relation to native title;
- uncertainties about identifying native title holders with whom to negotiate over future acts;
- the right to negotiate;
- the inclusion of prospecting and exploration licences in the right to negotiate process; and
- sources of delays in the right to negotiate process.

This section also covers the use of section 21 agreements and concludes with some observations on the complexity of the NTA.

Lack of clarity about native title

As noted in Section 8.2, the NTA relies on the common law for native title definition; there is no conclusive definition as such in the legislation itself. AMEC said that this:

> ... has led native title applicants to include demands for exclusive possession in their claims, coupled with in some instances ownership of minerals and waters. Rights sought, have consistently gone far beyond even 'fee simple' title and certainly exceed the rights contemplated by the High Court Mabo judgement. Such extravagant actions are encouraged by the Native Title Act itself because native title is not defined, yet compensation is equated with that which a holder of freehold title might expect to receive for effect. As a result, the aspirations of Aboriginal groups have been raised to unrealistic levels (Sub. 30, p. 18).

In contrast, the NLC said that the NTA does not contain a definition of native title because "to do so may limit or extinguish common law rights" (Sub. 44, p. 4). Moreover, it said:

> The NTA is drafted to ensure that, where the nature of native title rights has not yet been determined, native title is treated as the equivalent of freehold ... This ensures that decisions as to development or compensation do not breach the *Racial Discrimination Act 1975* ... (Sub. 31, p. 7).

The NTA contains provisions which can bear on the nature of native title. These are provisions which equate the treatment of native title holders with that of holders of ordinary title such as freehold title (for example, relating to compensation and to procedural rights of notification of future acts). Although an important reason for them is compliance with the RDA, in the absence of a determination of native title in a particular case, expectations may be raised among claimants that native title equates to freehold title; a view not shared by other parties to negotiations.

Significantly, the Commonwealth Government is considering a proposal to remove the current prohibition on the NNTT, other arbitral bodies and the courts referring to 'profits made', 'income derived' or 'any thing produced' when determining compensation payable for a future act subjected to the right to negotiate. Currently, the NTA permits only the parties themselves to refer to these bases in negotiated agreements about future acts. The proposal is intended to strengthen incentives of parties to negotiate agreements and "would not impact on the obligations of miners to make payments under State and Territory royalty regimes" (PM&C 1996, p. 17).

However, the proposal (together with the right to negotiate over grants of mineral tenements) could be construed as defining native title to include minerals rights. If such rights were vested not only in the Crown but also in native title holders, the fundamental lack of clarity about native title would be compounded by an additional ambiguity about the allocation of property rights over minerals on native title land. As the 'owner' of minerals, governments expect and receive a share of the economic rent generated by mining activity within their jurisdictions (including on native title land). However, the proposal above could enable claimants and native title holders to extract some proportion of that economic rent as well (see IC 1991, vol. 3, pp. 66-7).

Options and implications

It has been proposed that there should be a legislative definition. AMEC considered that the definition should be in the following terms:

> ... native title is defined as rights in land and includes, the right to pass over, camp on, take sustenance from, collect material from, conduct ceremonies on and enjoy traditional cultural pursuits, but does not include exclusive possession or the right to exclude others from the land the subject of native title (Sub. 30, p. 19).

Clarification of ambiguities about the nature of native title through a legislative definition would have a beneficial impact on investment incentives. It would reduce perceptions of risk as well as the costs for mining companies of gaining access to land.

There would be, however, a number of offsetting considerations depending on what the legislative definition entailed. A definition which expressly included minerals rights would amount to an explicit income transfer to Aboriginal and Torres Strait Islander peoples and require changes to existing royalty arrangements to reflect shared ownership over minerals. On the other hand, a legislative definition of the kind proposed by AMEC could limit the *Mabo (No.2)* definition of native title and amount to a partial extinguishment of native title, thereby raising questions about compensation. In both cases, potential breaches of the RDA could arise.

Legal uncertainty about pastoral leases

The most important source of uncertainty identified by participants is the unresolved status of pastoral leases with respect to native title. This is of concern to mining companies seeking grants and certain kinds of renewals of mineral tenements on pastoral leases, as well as to pastoralists seeking to vary the terms of their leases (for example, to vary land use activity on leases or to convert fixed term leases into perpetual leases), since they are required to negotiate with claimants and native title holders. The issue is complicated by the different forms of pastoral leases. In particular, some States and Territories have ‘reservation clauses’ reserving to Aboriginal people their traditional rights in relation to land (for example, rights of access to hunt for birds, fish and other foods, to obtain shelter or to have access for cultural or ceremonial purposes). [16]

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[16] The reservation clause under the Western Australian *Land Act Amendment Act 1934* provides:

Some participants found irony in the situation that currently applies to the extinguishing effect of past grants of pastoral leases under the NTA. Valid grants of pastoral leases made before the passage of the RDA are subject to the currently unsettled common law on extinguishment. In contrast, grants of pastoral leases made in the period after the RDA and before the passage of the NTA — which may be invalid because of the existence of native title — have been validated in accordance with the NTA, thereby extinguishing native title.

This inconsistency between valid and validated grants of pastoral leases applies despite the Commonwealth Government's view when it introduced the NTA that *all* past grants of pastoral leases (including those with reservation clauses) extinguished native title. In the second reading speech, the then Prime Minister drew attention to:

> ... the recording in the preamble of the bill of the government's view that under the common law past valid freehold and leasehold grants extinguish native title. There is therefore no obstacle or hindrance to renewal of pastoral leases in the future, whether validated or already valid (Keating 1993, p. 2880).

This view was confirmed recently (PM&C 1996, pp. 11-12).

As alluded to earlier, the common law on the extinguishing effect of pastoral leases is far from settled. For example, Professor Bartlett of the University of Western Australia (1993) noted that the status of pastoral leases was "problematic" because of the reservation clauses:

> The issue is unsettled because, although the majority [of the High Court in *Mabo No. 2*] seem to clearly favour the conclusion that pastoral leases extinguished native title, the reasoning is unconvincing. The clauses in pastoral leases spring from Imperial and historic concern to protect the Aboriginal people in the traditional use of their land, and a regard for their history and circumstances is likely to deny the requisite 'clear and plain' intention (p. xxii).

The issue was presented to the High Court for consideration recently in two cases involving claims in Queensland covering pastoral leases without reservation clauses — *North Ganalanja Aboriginal Corporation and Another For and on Behalf of the Waanyi People v. The State of Queensland and Others (1996)* and *The Wik Peoples v. The State of Queensland and Others (1996)*. In the *Waanyi* case, the High Court majority declined to rule on the issue on the ground that such a ruling would have been an "advisory opinion" which would not have been within its power to make (1996, p. 10). (The implications of this decision for the NNTT's approach to acceptance are considered later in this

> Aboriginal natives may at all times enter upon any unenclosed and unimproved parts of the land, the subject of a pastoral lease, to seek their sustenance in their accustomed manner (section 106(2)).

section.) The High Court heard the *Wik* case in June, but there has been no decision as yet.

Prior to the High Court's consideration of those cases, there were two Federal Court decisions in favour of the view that pastoral leases without reservation clauses extinguish native title. The legal status of these decisions has now been brought into doubt.

There continues to be debate about what the outcome on the pastoral lease issue ought to be. The South Australian and Western Australian Governments have told the Commission that it is their view that all pastoral leases extinguish native title. For example, the Western Australian Government has stated that its:

> ... clear view is that native title rights have been extinguished by a valid mining lease or the previous grant of a pastoral lease (with or without a reservation), in addition to [existing or former freehold and leasehold conferring exclusive possession, and Crown reserves which are inconsistent with the continued exercise of any native title] ... The State will continue to seek to have these important matters resolved by the Courts or through legislative actions (Cash 1995).

On the other hand, Aboriginal and Torres Strait Islander representatives considered that pastoral leases do not extinguish native title. The Aboriginal and Torres Strait Islander Social Justice Commissioner (1995b) said that the existence of a lease (including a pastoral lease):

> ... is not inconsistent with the continuation of native title. Even where a lease provides exclusive possession, that exclusive possession applies only for the term of the lease. The existence of a lease should be understood as having the effect of regulating native title rights for the period ... This approach should be adopted for all leases but is particularly appropriate for leases which apply for a short term. It is an insult to our culture to suggest that short-term leases extinguish tens of thousands of years of customs when the interference contemplated in the lease is negligible (p. 94).

The significance of this issue can be seen from Table 8.2 and Figure 8.4 which show how extensive the total area of pastoral leaseholdings is in Australia.

A number of participants emphasised the importance of the issue for Western Australia. The WA Department of Minerals and Energy noted that the State accounts for around one half of Australia's exploration expenditure and that 68 per cent of all mineral tenements are on pastoral leases. In addition, while all current pastoral leases in Western Australia contain reservation clauses, the Western Australian Land Information System estimated that about 30 per cent of them have had a history of pastoral leases approved with no reservation clauses.[17]

Options and implications

Participants have indicated that several options are available to the Commonwealth Government for dealing with the pastoral lease issue. One option involves the introduction of Commonwealth legislation to clarify the status of (valid) pastoral leases in relation to native title. Participants generally raised this in the context of legislation to provide that pastoral leases extinguish native title. However, the NLC considered that legislation equally could be used to recognise native title "regardless of the existence of historic (and current) tenure such as pastoral leasehold" (Sub. 31, p. 3). A second option is to leave the issue for the courts and the parties themselves to resolve. Other options include governments negotiating settlements with native title holders, regardless of historic land tenure, and excluding pastoral leases from the right to negotiate until there is a determination that native title has survived.

The key options raised by governments, as well as most other participants, were legislative extinguishment and judicial process (see Box 8.4). Legislative extinguishment was preferred by the Minerals Council of Australia (1996) and the South Australian Government (1995). They regarded this as a means of achieving certainty. The South Australian Government considered that judicial process would be "very time consuming, costly and would not necessarily satisfy all cases" (Sub. 45, p. 4). Other participants, however, argued that legislative extinguishment was neither legally nor economically feasible. The Aboriginal and Torres Strait Islander Social Justice Commissioner said that:

> Statutory extinguishment of native title is a constitutional, international and financial minefield. Even if the Commonwealth could find a way to achieve valid extinguishment of native title on pastoral leases, the complexity and risk involved in such a tactic would not promote certainty for land users (Sub. 26, p. 11).

[17] Pastoral leases with no reservation clauses were approved on the Department of Land Administration Register between 30 December 1932 and 21 January 1935.

Box 8.4: Implications of legislative versus judicial approaches to the pastoral lease issue

Legislative extinguishment

Outcome	*Key considerations*
Legislative amendments to the NTA that pastoral leases extinguish native title.	Outcome would apply effectively to all pastoral leases granted before and after the NTA. Implementation could be immediate. If there were no the challenge, duration of uncertainties about native title would be minimised. Legislation could become more complex as different pastoral leases must be taken into account. If the Commonwealth gave effect to this outcome by explicitly extinguishing native title, it would be under a constitutional obligation to provide just terms compensation. The extent of compensation is not known. If the Commonwealth suspended the RDA and allowed the States and Territories to legislate that pastoral leases extinguish native title, States and Territories would not be under an obligation to pay compensation. However, it is possible that the High Court could imply a right under the Constitution that States and Territories were liable for just terms compensation. If legislation was challenged and struck down by the High Court, uncertainties about native title could prevail for another 20 years.

Judicial process

Outcome	*Key considerations*
Courts decide that all pastoral leases (or only pastoral leases without reservation clauses) extinguish native title.	Outcome would apply effectively to grants of pastoral leases before 1975. No compensation issue would arise.
Courts decide that all pastoral leases do not extinguish native title.	Outcome would apply effectively to grants of pastoral leases before 1975. Could take the courts another 20 years to resolve uncertainties about native title. No compensation issue would arise.

The Commission notes that the Commonwealth Government declined recently to use legislation to extinguish native title on pastoral leases:

> ... if native title has survived the valid grant of a pastoral lease, then its blanket legislative extinguishment by the Commonwealth would probably be regarded as inconsistent with the principles of the RDA. In addition such extinguishment would, in all likelihood, involve an acquisition of property rights and thus require the Commonwealth to provide just terms compensation. Failure to do so could lead to the legislation being held to be invalid. Even if the Commonwealth legislation provided for just terms compensation (and it could be of a substantial amount), there are a number of other legal arguments available to indigenous interests. The ensuing litigation would pre-empt the certainty sought by the proponents of the legislative extinguishment option possibly for a long period (PM&C 1996, p. 12).

It is apparent to the Commission that neither legislative extinguishment nor the judicial process offers an easy way to resolve the issue. The following discussion sets out some of the main implications of these options.

Legislative extinguishment

If the Commonwealth legislated to extinguish native title, although the duration of legal uncertainty about pastoral leases could be reduced, it is likely that claims for compensation would arise (see Box 8.5).[18] This is because such legislative extinguishment could amount to the compulsory acquisition of property which, in turn, attracts Commonwealth liability under the Constitution for just terms compensation. In contrast, if the courts were to find that pastoral leases extinguished native title, no such liability for compensation would arise.

The total compensation bill under legislative extinguishment is difficult to determine. Indeed, a number of participants considered it to be ‘open-ended’. There are several reasons for this. First, the total bill would depend on a case-by-case determination of where native title had been extinguished by pastoral leases. Second, the basis for just terms is not defined precisely. It implies that the special attachment that Aboriginal and Torres Strait Islander people have for land may need to be valued — this would not be an easy task.

Box 8.5: Just terms compensation and legislative extinguishment of native title

[18] If the Commonwealth Government sought to avoid compensation altogether, it would need to introduce legislation to suspend the operation of the RDA in relation to the extinguishing effect of pastoral leases, thereby allowing the States and Territories to extinguish native title without the need to comply with the RDA. The States and Territories are neither obliged under the Constitution to pay just terms nor liable for compensation under their own constitutions.

Should the Commonwealth Government introduce legislation that pastoral leases extinguish native title, it could be liable under the Constitution to pay just terms compensation because such legislative extinguishment could amount to the compulsory acquisition of property.
Any assessment of just terms compensation would need to be done on a case-by-case basis. This is because compensation depends on the existence and content of the native title that has been extinguished.

The just terms criteria are not precisely defined under the NTA or under the Constitution (from where the primary obligation arises). Nor is there a valuation formula that can be used. Nonetheless, the following principles devised by the courts in the context of compulsory acquisition legislation may be of some guidance:

- just terms focuses on what is fair and reasonable in the particular circumstances and may not necessarily equate to the full monetary equivalent;
- just terms refers not only to the interests of the person whose rights are acquired, but also to general community interests;
- the courts have discretion in assessing just terms; and
- terms will not be considered unjust merely because they differ from ordinary and established principles of compensation law (see Stephenson 1995, pp. 145-6).

Even with these principles as a guide, it would be difficult to assess what just terms compensation for the extinguishment of native title would be in a particular case. For example, the Aboriginal and Torres Strait Islander Social Justice Commissioner (1995b) said:

> It is difficult to understand how a value can be put on the loss of freedom to exercise human rights and the loss of the ability to exercise traditional cultural lifestyles and the destruction of traditional cultural, social, economic, political and religious systems. The fact that the NTA talks in terms of "just terms compensation" and the possible right to other titles in exchange does not resolve this difficulty (p. 69).

A particular measurement problem is how the cultural and religious attachment which Aboriginal and Torres Strait Islander peoples experience in relation to the land can be valued (Stephenson 1995, p. 146).

It is possible that just terms compensation could encompass a wide range of financial amounts. It could extend to the market value of land, to the value of access for hunting or fishing or to the value of mineral resources. The latter might only be conceivable in a limited number of cases where ownership of minerals was consistent with traditional customs and laws.

It is because of the need for case-by-case determination of compensation and the difficulties posed by measuring just terms that it is said that the total compensation bill for legislative extinguishment of native title could be open-ended. Nonetheless, because the determination of compensation is likely to be slow, the total bill could be spread over a considerable period of time. The courts could also choose to award non-monetary compensation.

Even if the Commonwealth Government had chosen to pursue legislative extinguishment and considered the total compensation bill to be 'manageable', legal uncertainty about pastoral leases would not necessarily have been removed. Any legislation could be open to challenge in the High Court. (Some participants also noted political difficulties facing any attempts at legislative extinguishment.) In that event, the issue would return to the courts for decision.

Judicial process

Participants held differing opinions as to how long it would take for the High Court to decide whether or not pastoral leases of all types — especially those containing reservation clauses — extinguish native title and to build up a set of precedents that could be applied in a variety of circumstances and bind all courts.

Several participants told the Commission that this would take at least five years. For example, the Western Australian Government said that this might be the length of time needed for a claim by the Mirriuwung and Gajerrong peoples (involving pastoral leasehold land around the Western Australian and Northern Territory border) to reach and be decided by the High Court.

The NLC took a different view, arguing that a maximum of two High Court decisions would be necessary to resolve the pastoral lease issue. After referring to the current *Wik* case and noting that it deals with pastoral leases without reservation clauses, the Council said:

> If Aboriginal groups are successful, this decision will largely determine the issue throughout Australia. If Aboriginal groups are unsuccessful, the issue will nevertheless remain open in the NT, WA and SA [where there are reservation clauses]. A further case will be necessary whereby Aboriginal groups will argue that native title has been preserved by reservation clauses contained in the relevant leases (Sub. 31, p. 9).

However, the Aboriginal and Torres Strait Islander Social Justice Commissioner confirmed a report of his view that a High Court decision on the *Wik* case may not be definitive, as the case concerns only several of about 200 different types of leases (see Lane and McGarry 1996, p. 2).

A High Court decision on the *Wik* case would be a useful start towards resolving the uncertain status of pastoral leases with respect to native title. Several broad types of decision are possible, each having implications for the extent and duration of uncertainties about pastoral leases. On the one hand, either a decision that all pastoral leases (with or without reservation clauses) extinguished native title or a decision that no pastoral lease extinguished native title would reduce immediately all of the uncertainty about the status of pastoral leases. However, a decision confined to the facts of the *Wik* case (which relates to pastoral leases in Queensland without express reservation clauses), would leave uncertain the status of pastoral leases in States other than Queensland and would take additional time to resolve through the courts.

If there is a decision that allows for the co-existence of native title with pastoral leases, it is likely to take a long time — possibly 20 years — before the wider uncertainties about native title (for example, who holds it, where it continues to exist, and its content) are resolved through case-by-case determination.[19]

Given the importance of the pastoral lease issue for clarification of property rights, the Commission considers that test cases involving any outstanding matters of principle need to be heard and determined by the High Court as soon as possible.

It appears that the next available opportunity to address the issue of reservation clauses is a claim in Western Australia by the Mirriuwung and Gajerrong peoples, currently before a single justice of the Federal Court. The NLC, however, noted the complexity of that case and considered that other claims could be preferable as test cases.

Regardless of how the pastoral lease issue is resolved by the courts, it is important that any transaction costs and delays arising from the processes of the NTA be minimised as far as possible. Ways in which this could be done, consistent with the objectives of the Act, are considered in the remainder of this section.

Uncertainties about identifying native title holders

Concerns have been raised by mining sector interests about problems in identifying native title holders with whom to negotiate over future acts prior to a determination of native title. AMEC said:

> Mineral exploration and mining companies are currently unable to ascertain whether the Aboriginal representatives with whom they are dealing represent the valid native title holders or whether, upon the conclusion of a compensation agreement with one Aboriginal community, other Aboriginal groups may also claim an interest in the area (Sub. 19, p. 9).

The NTA contains provisions which can assist identification in two broad, albeit limited, ways.

First, there are provisions relating to the keeping of registers of claims and determinations of native title. However, even if there is an entry on a register recording details of native title determinations (including who are determined as

[19] For example, although Canada has recognised native title by means of treaties since 1763, and comprehensive claims (claims outside the treaty process) have been negotiated among various levels of government, public authorities, and indigenous people in that country since 1973, the extent of native title has not been completely resolved.

native title holders), it may not be conclusive. For example, an "approved determination of native title" may be varied or revoked because "events have taken place since the determination was made that have caused the determination no longer to be correct", or because the change is in the "interests of justice".

Second, notification under the right to negotiate process and the process for dealing with non-claimant applications can encourage claimants and native title holders to come forward in relation to a particular future act in a particular area. The notification period can operate also as a 'sunset' insofar as it denies to those with objections to the act the ability to participate in the processes after the notification period. The NNTT said in relation to the right to negotiate process:

> ... [The NTA] provides the benefit of knowing that, within the two-month s.29 notice period, all parties must be identified. No additional parties can seek the right to negotiate over the same activity when this two month period is over (Sub. 27, p. 6).

However, should the particular future act come up for renewal on terms that depart substantially from those originally set, or should another future act in the same area be proposed, then claimants and native title holders again must be notified and have an opportunity to lodge objections within the notification period.

Furthermore, while notification may 'flush out' claimants, there is no guarantee that they hold or continue to hold native title. Several possibilities may arise:

- only claimants who are determined subsequently as native title holders respond;
- only claimants who are determined subsequently as not holding native title respond;
- no-one responds; and/or
- multiple claimants (including competing claimants) respond, some of whom are determined subsequently as native title holders, while others are not (see Altman 1996, p. 5).

The last possibility, the emergence of multiple claimants, was seen by mining sector interests as causing a significant problem for negotiations, particularly in the goldfields region of Western Australia. The Allen Consulting Group (1996) reported:

> If Western Australia is Australia's native title "hot spot", the Goldfields region is where the "heat" is most intense. 20 native title claims have been accepted for land in the ... region ... In one enterprise's case, its operations ... are subject to 12 native

> title claims. Five of these claims overlap. Some are competing claims made by different groups within a family (p. 13).

Aboriginal and Torres Strait Islander representatives acknowledged the problem of multiple claimants. The NLC observed that it was caused by the ability of individuals under the NTA to lodge claims on behalf of a group of native title holders without consulting those in the group. The Council said:

> Now, instead of saying ... the nature of native title is a communal one ... and that the Act therefore should reflect ... its communal nature and refer always to a group of native title holders, the Act instead refers to individuals. Industry, instead of recognising that that's the conceptual confusion in the Act, want the rights of native title holders extinguished, the rights of native title holders to negotiate to protect their native title interests extinguished, because they find it inconvenient to deal with these — in some cases in one area, over 100 — overlapping claimant applications by individuals. Likewise we find that extremely inconvenient, primarily because it is contrary to the nature of Aboriginal customary law (Transcript, pp. 42-3).

Options and implications

A key issue is whether any problems in identifying native title holders can be reduced further under the NTA. The problem of multiple claimants is, as Altman (1996) suggested, a particularly difficult case requiring a "creative policy solution" (p. 5).

Two possible options have been raised: the inclusion of a sunset clause in the NTA; and conferring particular powers on NTRBs.

Sunset clause

Mining sector interests have proposed the inclusion of a 'sunset clause' in the NTA as a device for reducing uncertainties involved in identifying native title holders. The Chamber of Mines and Energy of Western Australia drew the Commission's attention to a proposal by the Australian Mining and Petroleum Law Association (AMPLA) to the former Prime Minister involving:

- a one year period in which all claims must be lodged to be valid;
- a two year period in which claims must be decided (the resolution period); with
- no lodgment of claims being possible after the resolution period (AMPLA 1995, p. 6).

Under AMPLA's proposal, the sunset clause would remove the ability of claimants to lodge claims under the NTA after a certain time.[20] Several observations can be made about this.

First, the proposal would not affect the ability to claim native title under the common law. Hence, it is questionable whether it would reduce all uncertainties about identifying native title holders. For instance, the Aboriginal and Torres Strait Islander Social Justice Commissioner said claimants would then "be forced to rely on common law remedies to protect their property rights" (Sub. 50, p. 4).

Second, the proposal may not be as cost-effective in eliciting claims as the current right to negotiate or the non-claimant processes under the NTA. For example, if the sunset clause were to take effect in the time proposed by AMPLA, it might lead to a large influx of claims in a short period of time. This could place such severe pressure on available resources that they would be diverted from claims over areas whose determination might be of higher importance to the Australian community. (This risk would be reduced if the sunset clause were to allow claims to be lodged over a relatively lengthy period of time, but that would weaken the purpose of the proposal.)

Native title representative bodies

NTRBs have a significant role to play under the NTA.[21] They can represent claimants in negotiations with mining companies and others under NTA processes, assist in making claims and in resolving disputes among claimants, and assist companies and others in identifying claimants.

There are several notable aspects about the NTA provisions. First, the statutory functions conferred upon NTRBs are not mandatory. Second, the bodies do not have regional monopolies in native title representation. Third, under arrangements administered by ATSIC, native title-related funding is directed to the bodies rather than to other types of representation (including self-representation). However, claimants can obtain assistance from the Attorney General's Department (for example, legal aid funding) and the NNTT (for example, assistance in the preparation of claims).

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[20] In the ALRA, a 10 year sunset period on making traditional land claims was inserted in amendments in 1987.

[21] Under the NTA, the Commonwealth Minister determines whether a body is a NTRB on the basis of the following criteria: that the body is 'broadly representative' of Aboriginal or Torres Strait Islander people in a particular area; and that the body 'satisfactorily' performs its existing functions as well as functions under the NTA.

The Commonwealth Government is currently considering proposals to "strengthen" the role of NTRBs (PM&C 1996, pp. 28-32). Key proposals are to:

- expand the functions of the bodies under the NTA to include: identifying potential claimants within the body's designated area; "endorsing" claims, with endorsement being a condition of registration (and, as noted later, of gaining the right to negotiate); coordinating claims and determining priorities between claims; and participating in negotiations if requested;
- make the bodies' functions under the NTA mandatory;
- define the area of operation of each body so that there is no overlap;
- improve the bodies' accountability to the public and to their clients by introducing review and appeals procedures (and a requirement to prepare a corporate plan); and
- require a body to "brief out" work relating to a claim where it is not possible to combine all claims into a single claim; and
- enable the Commonwealth Minister for Aboriginal and Torres Strait Islander Affairs to direct a body to fund a claim in exceptional cases.

In addition, under the Native Title Amendment Bill, claimants no longer would be able to obtain assistance from the Attorney General's Department. Assistance would continue to be available largely from ATSIC and, to a limited extent, from the NNTT. In effect, this would channel most Commonwealth Government assistance to claimants through the NTRBs.

As justification for these proposals (as well as for the proposed amendment to funding), the Commonwealth Government referred to a 1995 review of NTRBs by a committee reporting to ATSIC (1995b) (which expressed concern about the inadequacy of provisions in the NTA applying to the bodies) and stated:

> [The proposals] recognise the importance of effective representative bodies to the smooth operation of the NTA, particularly the future act processes, by providing an efficient, coordinated and expert service to native title holders and claimants in their dealings with the NNTT and the Federal Court, government and industry (PM&C 1996, p. 28).

In the context of how problems in identifying native title holders can be reduced, the proposal relating to endorsement of claims by NTRBs (with scope for "briefing out" to occur) is of particular relevance.

A potential advantage of the proposal is that the transactions costs arising from negotiations with multiple claimants could be reduced. This could occur if the NTRB succeeded in mediating and conciliating disputes amongst competing claimants before endorsement and, hence, before the right to negotiate was exercised.

However, there are some difficulties with the proposal.

First, it is not clear whether NTRBs would have sufficient incentives to exclude claimants from the right to negotiate process. For example, in the context of the multiple claimant problem in the Western Australian goldfields, the NLC said:

> We realise that it's a problem. But ... along with the lack of resources we have the problem of the status and good reputation of bodies such as our own. Why should we try to sort out something that could turn into a very nasty situation and put our staff in the front line, as it were, to sort out these problems that were not of our making ... (Transcript, p. 56).

Indeed, Altman (1996) observed that "some NTRBs, like the New South Wales Aboriginal Land Council, do not want a mandatory role and currently encourage industry and native title parties to negotiate directly (as in the case of the proposed Moomba Pipeline)" (p. 14).

Second, the proposal may raise a conflict of interest for NTRBs. For example, the NLC (1996) said that the proposal means that a body, "having made a decision to fund and represent native title claimants, will then be required to make an endorsement decision ... effectively ... on behalf of the [NNTT] registrar" (p. 4). ATSIC (1996) considered the proposal to be potentially unconstitutional because it could be interpreted as involving the exercise of judicial power (p. 13).

Third, if NTRBs were unable to resolve disputes among competing claimants, costs may not be reduced significantly. A refusal to endorse a claim could be appealable. There also could be endorsement of more than one claim with the effect that negotiations with multiple claimants with conflicting interests could still be required.

There are various alternatives to the endorsement proposal. They include relying on the registration test as currently proposed in the Native Title Amendment Bill (see later), requiring NTRBs to report to the NNTT on the consultation processes undertaken with claimants and native title holders prior to the lodgement of claims, and conferring a monopoly role on the bodies in representation.

A number of Aboriginal and Torres Strait Islander representatives favoured conferring a monopoly role on NTRBs. While the precise details of implementation are not clear to the Commission, it appears that giving the bodies a 'signing off' power when negotiating agreements with mining companies is an important element. For example, the NLC proposed that this power be used in respect of all NTA processes and be modelled on the powers given to Land Councils and Aboriginal Land Trusts in the Northern Territory under the ALRA. This appears to go beyond charging the bodies with the tasks of identifying and obtaining the 'informed consent' of claimants. It could be viewed as similar to a power of attorney whereby persons give others the power to represent them or act on their behalf in respect of certain matters.

The Allen Consulting Group (1996) reported that, while some Western Australian mining companies expressed a desire to communicate directly with claimants, others supported the role of NTRBs as providing a single, central body to deal with in a particular region. It noted that companies operating in the Western Australian goldfields are looking to the bodies to resolve the current situation of multiple, overlapping and competing claims (p. 21).

Conferring a monopoly role on NTRBs would have several advantages. Like the endorsement proposal, it could reduce transaction costs associated with identifying native title holders. The authority and responsibility accorded to the bodies might constitute a strong incentive to resolve competing claims. And it would appear to allow more scope for bodies to push through an agreement where differences remain.

However, this alternative could have some disadvantages similar to the endorsement proposal. There may still be potential for conflict of interest to the extent that NTRBs would be essentially deciding the relative merits of constituents' claims as well as exercising an advocacy role. And the bodies may find it difficult to resolve disputes among claimants if their authority was not respected.

Further difficulties could arise because claimants would be compelled to accept NTRBs as their representatives in negotiations affecting their interests, even if they preferred alternative forms of representation. Denying claimants this choice could reduce the incentive of bodies to perform efficiently. BHP said that:

> Experience with ... monopolistic Aboriginal bodies, such as some land councils, has indicated inefficiencies in dealings which may have been overcome if the Aboriginal people had been able to appoint their own representatives (Sub. 38, p. 4).

Adequate safeguards would be needed to ensure property accountability. The Allen Consulting Group (1996) reported the observations of some Western Australian mining companies that NTRBs were pursuing objectives that did not necessarily accord with the interests of those they represent (pp. 21-2).

Greater use of NTRBs could be of assistance in addressing the problem of identification of native title claimants. However, both the endorsement

proposal and conferring a monopoly role on NTRBs have significant disadvantages. If either approach were chosen, it would be important that its effectiveness be reviewed within three years.

To the extent that the screening test for claimants gaining the right to negotiate is contributing to the claimant identification problem, a strengthening of the test would assist. This is considered below.

The right to negotiate

The NTA provides claimants, as well as native title holders, with the ability to participate formally in negotiations in a process applying to future acts, as long as certain conditions relating to registration and acceptance are satisfied.

The reasons for conferring this right to negotiate stem largely from the Commonwealth Government's recognition of the attachment that Aboriginal and Torres Strait Islander people have to land. In the second reading speech, the then Prime Minister said:

> This emphasis on Aboriginal people having a right to be asked about actions affecting their land accords with their deeply felt attachment to the land. But it is also squarely in line with any principle of fair play. It is not a right of veto (Keating 1993, p. 2990).[22]

Two features of the right to negotiate are considered below: its extension to claimants; and the conditions which need to be met. The Commission notes that non-conferral of the right to negotiate does not prevent claimants and native title holders from negotiating with others about future acts outside the NTA.

Extension of the right to negotiate to claimants

Mining sector interests have raised concerns about claimants having the right to negotiate. Many of their concerns are linked to the practice of immediate registration and the standard of the acceptance test (see below).

There appear to be several possible reasons for the extension of the right to claimants. One relates to the delays involved if a future act could not proceed until there was a determination of native title. A second reason is that, if a future act was allowed to proceed in an area without a determination of native title and without consultation with potential native title holders, a liability could arise in the future. A further reason offered by the Aboriginal and Torres Strait Islander Social Justice Commissioner is that the right is not a "statutory gift"

[22] It is notable that, in the period before the passage of the NTA, Aboriginal and Torres Strait Islander representatives were advocating a right of veto (see Altman 1995, p. 7).

which is given to claimants, but rather an "entitlement arising from pre-existing rights to land" (Sub. 50, p. 5).

Prerequisite conditions — registration and the acceptance test

Concerns about the right of claimants to participate formally in the right to negotiate process tend to be reinforced by the nature of requirements for the registration and acceptance of claims.

Once the NNTT receives a claim in the prescribed form, it is immediately placed on the Register of Native Title Claims before being considered for acceptance. The practice of immediate registration has been in operation only since September 1995 following a decision by O'Loughlin J of the Federal Court in *Northern Territory v. Lane (1995).* Immediate registration is significant, because it gives claimants a right to negotiate on certain future acts until such time as the claim is rejected by the NNTT (which, of course, might not happen).

Claims (and non-claimant applications) are subject to limited screening by the NNTT for acceptance. There are two parts to screening. First, the claim must be accompanied by any prescribed documents and any fee, and it must satisfy basic information requirements (for example, a description of the area over which native title is claimed). Second, the claim must be accepted by the NNTT unless it is considered to be 'frivolous' or 'vexatious' or that 'prima facie' it cannot be made out (often called a 'negative' prima facie test). The second part is known as the acceptance test.

The High Court recently clarified the application of the acceptance test under the NTA in the *Waanyi* case. A key principle from the majority judgment was that the power of the NNTT in relation to the acceptance of the claim is of an administrative nature and, as such, should not be exercised to reject a claim where, on the information in the claim and the material accompanying it, there are questions of fact and law that are "fairly arguable".[23] The main rationale for this principle is a concern about the NNTT making a decision that is fatal to a claim proceeding to the courts.

The practical effect of the High Court's decision on the NNTT's approach to acceptance is that the NNTT is now accepting most claims other than those which, at face value, relate to land subject to freehold title. However, if there

[23] Other key principles from the majority judgment were that: the phrase prima facie relates to the interest or title to which a claimant may be entitled on the face of information contained in, and the material accompanying, the claim; and information and material obtained from third persons are irrelevant to the opinion that the NNTT has to form as to whether, prima facie, the claim can be made out by the claimant.

were a binding judicial precedent — for example, stating that pastoral leases extinguished native title — then this would become a basis for rejecting claims.

Immediate registration has been criticised in several reports. The Allen Consulting Group (1995a) reported:

> The O'Loughlin decision appears to make irrelevant the first step in the NNTT process of assessing claims by automatically awarding 'right to negotiate' status to any native title claimant regardless of the worth or otherwise of their claim (p. 9).

The Western Australian Government (1995) reported:

> The Federal Court decision ... requires that claims be registered on lodgement and before the assessment of land tenure can be carried out, thus enabling the registration of claims in regard to any land including freehold and leasehold without the reservation for Aboriginal access (p. 3).

Participants have drawn attention also to inadequacies in the acceptance test in screening out claims. The main focus of their concern is that claimants are not subject to a 'positive' prima facie test. For example, one participant pointed out that claimants need not provide evidence of a connection with the land in accordance with traditional customs and laws. These concerns were raised prior to the High Court's decision in the *Waanyi* case.

Under proposed amendments in the Native Title Amendment Bill, the right to negotiate would continue to be granted to registered claimants and native title holders. There would be no acceptance as currently occurs under the NTA. Claims would be registered only after being subject to a possible process of 'strike out' by the Federal Court as well as to an assessment by the NNTT against a 'registration test'.[24] A claim that fails the registration test could still proceed through the Federal Court to a determination, but the claimants would not have a right to negotiate. The Commonwealth Government said:

> The registration test is intended to ensure that only claims with some prospect of success attract the benefits given to registered native title claims under the NTA (Howard 1996, p. 23).

There are several aspects to the registration test:

- the NNTT must consider that, prima facie, the claim can be made out (that is, a positive prima facie test);

[24] Some of the proposed amendments in the Native Title Amendment Bill are intended to address potential invalidities in the NTA caused by the *Brandy* decision. The responsibility for receiving all native title claims and compensation applications, controlling the proceedings and making native title and compensation determinations would be withdrawn from the NNTT and conferred on the Federal Court. The Federal Court must refer claims to the NNTT for notification, registration and mediation.

- claimants must provide information about the claim, including details about the area claimed, any tenure searches, native title rights and interests claimed, the factual basis for the claim (for example, the traditional connection of the claimants) and the group identity of the claimants;
- reasonable searches relevant to the determining the existence of interests in the area claimed must be carried out; and
- the NNTT cannot register a claim if aware, through information contained in the claim or provided by governments, that the area claimed is or has been subject to freehold title or residential or commercial leases (other than pastoral leases).

The Commonwealth Government is currently considering whether an additional condition for registration should be NTRB endorsement (PM&C 1996, p. 30).

Although these proposed amendments were welcomed by some participants such as the South Australian Government, Aboriginal and Torres Strait Islander representatives expressed concern. The Aboriginal and Torres Strait Islander Social Justice Commissioner said that, while he was not opposed in principle to a registration test, there could be a multiplicity of screening procedures consisting not only of the registration test but also of Federal Court strike out procedures as well as endorsement by NTRBs. He said that this “is likely to be onerous for claimants and creates potentially inefficient duplication” (Sub. 50, p. 6).

Options and implications

Because negotiations must proceed with registered claimants in the absence of a determination of native title, excessive costs may emerge from the exercise of the right to negotiate. An example of this is where the approval of a future act has been held up and involved other costs because a registered claimant, who is later found to have no native title, objects to the future act and exercises a right to negotiate. In this case, the transaction costs could be viewed as being unnecessarily incurred. Another example is where there are multiple registered claimants exercising a right to negotiate in relation to future acts. As a general rule, the more parties to negotiation, the greater the costs in sorting out competing claims.

It is important that transaction costs associated with the exercise of the right to negotiate be kept to a minimum consistent with the objectives of the NTA. For mining companies, the prospect of high transaction costs is likely to affect their decision to invest in exploration and production in areas that are potentially claimable. There are also adverse effects for those Aboriginal and Torres Strait

Islander people with legitimate claims. For example, resolution of the issue for them may be delayed.

The Commission notes that the Commonwealth Government is considering a proposal to limit access to the right to negotiate to native title holders (PM&C 1996, p. 16). If claimants were denied the right to negotiate, transaction costs may be reduced in the short term. However, this may be offset by the risk of compensation liabilities by mining companies in the long term in the event that claimants later obtain a determination of native title in their favour. There may also be further adverse effects on potential native title holders not being able to protect any native title they may have at the time the activity is proposed.

If claimants retain the right to negotiate, the basis for exercising the right is most important, especially while the legal question about pastoral leases remains unresolved. The Commission notes the preference of the Aboriginal and Torres Strait Islander Social Justice Commissioner for a registration test based in part on the proposed amendments introduced in 1995 (and similar to the current acceptance test), for NTRBs to have a reporting role in relation to claims for lodgement, and for a moratorium on strike out procedures until mediation has been completed.

The current acceptance test as clarified recently by the High Court in the *Waanyi* case may be appropriate for the purpose of dealing with claims for a determination of native title. However, for the purpose of conferring a right to negotiate in a formal process governing future acts, the hurdle should be higher. It seems appropriate to require claimants to bring forward more substantial evidence in support of their claim. Such a requirement could be imposed without prejudicing the ability to pursue claims for a determination of native title.

The Commission considers that a more thorough screening test should be applied to claims before the right to negotiate is given. Proposed amendments in the Native Title Amendment Bill for a registration test would serve this purpose.

Inclusion of prospecting and exploration licences in the right to negotiate process

Concerns were raised by mining sector interests about prospecting and exploration licences being included in the right to negotiate process. In particular, participants said that exploration was a high-risk activity which was not very intrusive. Moreover, they noted that, because these tenements are included, there is ‘disjunctivity’ in that prospecting and exploration licences and mining leases must be subjected separately to the process.[25] This is considered to create disincentives for investment.

As noted earlier, the States and Territories (apart from Western Australia) have avoided subjecting these tenements to the full process.

Options and implications

The Commonwealth Government is considering a proposal to exclude prospecting and exploration licences from the right to negotiate process. Where an exploration licence authorises production or de facto mining activity, the Commonwealth Minister could agree to extend the right to negotiate. In support of this proposal, the Commonwealth Government noted that exploration is frequently a “loss-making activity” and said:

> There is an argument that negotiations over exploration titles ... offer little scope for profit-sharing arrangements, employment opportunities or other social or infrastructure benefits, all of which were intended to flow to native title holders and their communities from the right to negotiate process. ... Moreover, although the situation varies across the States and Territories, many prospecting and exploration activities involve minimal or no physical impact on the land and ... those activities are regulated in any event under relevant State and Territory planning, environmental and heritage legislation (PM&C 1996, p. 13-14).

The Commonwealth Government is considering also the continued utility of the expedited procedure as well as the Commonwealth Minister’s exclusions power. In respect of the latter, the Commonwealth Government noted that, when the NTA was enacted, it was envisaged that activities having only a minimal effect on native title would be excluded from the right to negotiate by means of a Ministerial determination. However, this has “not turned out to be possible under the NTA as currently drafted” (PM&C 1996, p. 13).

Several participants supported the exclusion of prospecting and exploration from the right to negotiate process. AMEC pointed out that exploration is a high risk activity, causes little ground disturbance and is, in any case, subject to Aboriginal heritage, environmental and other protective legislation in each State and Territory. However, it noted a “judicial weakness” in that claimants could lodge an injunction to prevent exploration activity pending the outcome of a claim (Sub. 30, p. 21).

While supporting a general exclusion, the South Australian Government noted the potentially significant impacts of “test production” during mineral

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[25] In contrast, under the ALRA, a ‘conjunctive’ framework for all negotiations is required. This means that the consent of land councils is not required at the production stage, but at the exploration stage.

exploration and thus considered it “reasonable” that this activity be subject to the process (Sub. 45, p. 5).

And BHP said that:

> Ideally, BHP would like the once only right to negotiate ... to apply at a time nominated by the developer on the basis that the developer is in the best position to decide when a project has progressed to the stage where there is sufficient information to enable meaningful negotiations to occur. However, native title parties may have concerns about the timing of negotiations being determined by the developer and, accordingly, BHP agrees with the Federal Government’s proposal to exclude exploration and prospecting from the right to negotiate process (Sub. 38, pp. 4-5).

However, Aboriginal and Torres Strait Islander representatives objected to the exclusion of prospecting and exploration licences from the process. The Aboriginal and Torres Strait Islander Social Justice Commissioner said that the impact of exploration should not be assessed according to “a non-Indigenous, ‘western’ framework which contemplates only the physical impact of activities on land”:

> Exploration licences often permit extensive activity, such as the large scale removal of soil. It is therefore unrealistic to argue that exploration has a low level of impact on the land and will not affect native title holders’ enjoyment of their rights. Further, Indigenous occupation and use of land may be affected my mining companies entering or behaving inappropriately in areas of significance or by dealing in a culturally inappropriate way with native title holders (Sub. 50, p. 3).

Patrick Dodson, Chairman of the Council of Aboriginal Reconciliation, also told the Commission that protective clauses normally contained in the tenements were insufficient to protect native title, particularly in relation to any spiritual or cultural impacts of prospecting and exploration. Furthermore, he noted that, if claimants and native title holders were denied the right to negotiate over exploration, this may damage the ability of mining companies to obtain a grant of a mining lease at a later stage.[26]

The Kimberley Land Council, after noting that Western Australian heritage legislation is not effective in addressing native title rights, drew attention to other problems (see 1996). These include the use of a ‘community interest’ test in determining sites of significance, the over-ride power of the Minister, the inability of Aboriginal people (apart from private landowners) to appeal against the Minister’s decision and the inadequacy of fines and registers.

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[26] In a similar vein, concerns were raised also about the use of the expedited procedure by the Western Australian Government.

The NLC noted that the proposal:

> ... will encourage the use of common law rights, the RDA and heritage legislation. This will undermine the objective of delivering certainty to non-indigenous land users, and will promote a purely adversarial approach to questions of land use (Sub. 31, p. 24).

If prospecting and exploration licences were excluded from the right to negotiate, attention was drawn by some Aboriginal and Torres Strait Islander representatives to the potential for a work program clearance process, as used by the Kimberley Land Council in relation to Aboriginal heritage legislation, to ensure that the impacts of prospecting and exploration were kept to a minimum. This process involves mining companies providing the Council with a program of intended exploration work in order to check that damage to Aboriginal heritage areas is avoided. Use of the process is not mandatory. Sullivan (1996) of the Institute of Aboriginal and Torres Strait Islander Studies stated that:

> If procedures along these lines were proposed by the States as part of the process of applying for and getting the necessary clearances for exploration activity, the exclusion provisions, although seen by many Aboriginal people as unjust, could be workable (p. 6).

It is apparent to the Commission that a proposal which excludes prospecting and exploration licences from the right to negotiation process raises a number of competing considerations.

First, the proposal would remove a regulatory hurdle at a stage of mining activity where there is likely to be significant uncertainty about commercial outcomes. Instead of being obliged to negotiate with claimants and native title holders at the prospecting and exploration stage and again at the production stage, mining companies would be required to negotiate only once — at the production stage.

Nonetheless, some inflexibility in the statutory timing of negotiations would be retained. From a mining company’s perspective, it would be desirable if the right to negotiate process was flexible enough to allow any type of agreement; whether ‘conjunctive’ or ‘disjunctive’; whether at the exploration stage and/or at the production stage. While the proposal would not preclude companies from entering into agreements prior to exploration, the validity of such agreements could be at issue (see discussion on section 21 agreements).

A second consideration is, as the Commission noted in the draft report, that it is not clear that the impacts of prospecting and exploration activity would be addressed adequately by protective clauses in tenements in relation to environmental and Aboriginal heritage legislation. Such legislation was never intended to address native title concerns. Any protection would be limited to specific kinds of impacts such as on sites of significance. Even within this narrower context, the effectiveness of such legislation has been questioned in reports to governments (for example, see Minter Ellison Northmore Hale 1995 on the Western Australian Aboriginal Heritage Act).

Nonetheless, the Commission notes that claimants and native title holders would retain procedural rights (such as notification) which would place them in a position similar to that of pastoral leaseholders. Importantly, claimants and native title holders would continue to have available to them court remedies, such as injunction. Their ability to seek court remedies may induce mining companies to begin negotiations at a stage earlier than production. In any case, companies may face an incentive to seek out claimants and native title holders early to ensure that negotiations at the production stage proceed smoothly. However, it is not clear how strong this incentive is likely to be.

A final consideration relates to the effectiveness of the expedited procedure as an alternative. In the draft report, the Commission considered that, based on evidence at the time, the expedited procedure was a worthwhile inclusion in the NTA and would best address the mining sector's concerns about prospecting and exploration licences. Since then, however, a Federal Court decision now requires the NNTT to consider non-physical impacts (see Section 8.2). The effect of this decision on the use of the expedited procedure is uncertain, but it could increase the number of successful objections.

On balance, the exclusion of prospecting and exploration licences from the right to negotiate process is likely to be more effective than the expedited procedure in reducing transaction costs. However, some types of exploration activity could have significant impacts on native title. Accordingly, the Commission considers that if exclusion is implemented, it should not apply to activity resembling test production. There is a need also to address concerns about the adequacy of Aboriginal heritage legislation.

Sources of delays in authorising future acts

Specific concerns were raised about delays associated with the NTA's right to negotiate process, particularly in Western Australia. For example, on the extent of delays, the WA Department of Minerals and Energy said:

> To date, the impact of the NTA procedures has been to delay the grant of 95 per cent of [prospecting and] exploration titles by about 3 months with most of the remaining 5 per cent being resolved after delays of 5 to 6 months ... The impact on applicants for mining leases has been much greater, as 76 per cent ... of ... applications to have completed the two months notification period over the last 12 months are subject to negotiations between the applicants, the native title parties

> and the State Government. To date eleven agreements have been reached in relation to twenty one cases involving twenty seven mining tenements (Sub. 43, attachment 3).

However, the Aboriginal and Torres Strait Islander Social Justice Commissioner (1995a) considered that the delays to the grant of most tenements as a result of the NTA have been minimal (p. 176).

The time taken for an application for a mineral tenement to proceed under the right to negotiate process can vary according to the circumstances. Significant factors are whether an expedited procedure applies to the future act and, if not, whether any right to negotiate arises and is exercised.

In Western Australia, the expedited procedure is being used in relation to all applications for prospecting and exploration licences. Only 6 per cent of these have attracted objections (see Table 8.1 in Section 8.2). The typical time taken for these grants to be finalised under the right to negotiate process is three months. Where there are objections, the time taken by the NNTT to deal with them is between two and four months. By comparison, the notification of 77 per cent of applications for mining leases — that is, tenements which do not attract the expedited procedure — has attracted the right to negotiate and, hence, these are taking longer to be authorised. The first batch of applications for arbitration by the NNTT was determined after approximately six and a half months. However, the Commission understands that there is currently a delay in NNTT arbitration of applications as a result of a recent Federal Court decision (see below).

In the face of complete opposition to the grant of mineral tenements, such that the statutory periods in the process ran their course, the right to negotiate process would take a minimum of 12 months in relation to prospecting or exploration licences and 16 months in relation to mining leases. This assumes that prospecting and exploration licences would not attract the expedited procedure and includes:

- a period necessary for State or Territory legislative and administrative processes to be satisfied;
- a period necessary for the preparation and issuing of notices pursuant to the NTA;
- a two month period under the NTA after notification for responses to be received (under the Native Title Amendment Bill, this period would increase to three months to enable claimants to meet more stringent requirements for registration);

- a 'minimum' negotiation period under the NTA of four months for prospecting and exploration licences and six months for mining leases (which could include the notification period);
- a 'maximum' period for inquiry by the NNTT and determination of four months for prospecting and exploration licences and six months for mining leases; and
- a two month period under the NTA within which the relevant Minister can overrule the NNTT's determination.

There is scope for the periods to be much longer. Delays of an ongoing nature may arise from the lack of interface between the NTA and State and Territory legislative processes and in relation to the NNTT's arbitration power.

Lack of integration between jurisdictions

Participants drew attention to the lack of integration between State and Territory and NTA processes. AMEC said:

> At present, the determination process prescribed by the Native Title Act does not readily interface with the formal land title systems operated by the States and Territories, or with the deeply embedded commercial processes which form society's basis for commerce and trade (Sub. 19, p. 8).

Under the NTA, the right to negotiate process applies when a future act is 'proposed' to be done by governments. The Western Australian Government has interpreted this to mean that, once it receives an application to grant a mineral tenement, it must first go through the process embodied in its mining regime (for example, notification, Wardens Court and so on) before initiating the right to negotiate process. It also undertakes tenure searches before it subjects an application for a grant to the right to negotiate process. It considered that running its processes in parallel with the right to negotiate process (parallel processing) would not be practical where applications for mineral tenements were contested under its mining regime.

Others, however, considered that the NTA does not prevent the States or Territories from parallel processing.

As noted in Section 8.2, the NTA provides for the States and Territories to manage their own future acts regimes, subject to obtaining the agreement of the Commonwealth Government. This would allow the States and Territories to integrate the right to negotiate process with other legislative processes (such as required under environmental planning and mining regimes) and, in effect, offer a 'one-stop shop'.

The NNTT's arbitration power

Another possible source of delay arises in relation to NNTT arbitration over future acts.

A recent decision by the Federal Court is likely to have an impact on when the NNTT should *commence* arbitration. In *Walley v. The State of Western Australia and Others (1996)*, Carr J held that, in relation to negotiations over a future act, if a government party has not complied with its obligation to negotiate in good faith with other parties, none of the parties can seek NNTT arbitration. In response to concerns about delays that this would cause, he said that, while there was a risk of proceedings before the NNTT being "bogged down":

> ... it is likely that the Tribunal will devise methods for rapid determination of this preliminary issue so that time will not be unnecessarily consumed. The Tribunal is well placed to recognise and deal with delaying tactics should they be employed (pp. 20-1).

Subsequently, the NNTT has outlined the type of actions a State should undertake to ensure that it fulfils its obligations before seeking arbitration. These include facilitating meetings, responding within reasonable time frames to correspondence and taking reasonable steps to engage in discussions with the parties (NNTT 1996c). It is considering now with the Western Australian Government and other parties the future conduct of matters for arbitration and the workload implications. The Commission understands that the backlog of applications for arbitration is increasing.

The arbitration stage itself could well go beyond the prescribed time limits in the NTA because of the NNTT's obligation to take into account a wide range of matters.[27] Moreover, the maximum periods of four and six months which apply are not strict deadlines. Under the NTA, the NNTT is obliged only "to take all reasonable steps" to arbitrate within those time periods.[28] Nonetheless, the Aboriginal and Torres Strait Islander Social Justice Commissioner has argued that the time frames in the NTA are strict and unlikely to be exceeded. Moreover, he said "the time frames have caused enormous difficulties for native title claimants trying to protect their rights" (Sub. 26, p. 5).

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[27] Section 39 of the NTA sets out a list of factors which the NNTT must take into account, including the effect of the proposed act on: claimants and native title holders; their culture and traditions; the natural environment; the interests, proposals, opinions or wishes of claimants and native title holders; the economic or other significance of the proposed act; the public interest; and any other matter considered relevant.

[28] The NTA does not define what this means.

Options and implications

The Commonwealth Government is currently considering proposals to encourage parallel processing and to impose shorter time frames for arbitration (as well as negotiation) of future acts (PM&C 1996, p. 16).

Several participants from the mining sector advocated options to reduce delays associated with the right to negotiate process. AMEC considered that time frames should be established which recognise commercial reality and which do not develop into lengthy time delays; and that native title should be accommodated in the formal land title systems operated by the States and Territories. The Minerals Council of Australia said that requirements in the NTA need to be "streamlined" to reduce delays (Sub. 24, p. 32).

Aboriginal and Torres Strait Islander representatives held varying views about the options. The Aboriginal and Torres Strait Islander Social Justice Commissioner favoured review by the States and Territories of their procedures for issuing mineral tenements in order to ensure that they complement the right to negotiate process. The NLC opposed parallel processing and considered that there are other ways to fast-track agreements, such as through improvements to section 21 (see later). Moreover, it opposed imposing enforceable time limits on the NNTT:

> This would limit the effectiveness of the Tribunal's decision-making by potentially limiting the evidence that could be considered and the claimants who could be notified (Sub. 31, p. 10).

It is important that the right to negotiate process ensures that the interests of potential native title holders are dealt with adequately and, at the same time, that there are no undue delays in obtaining a mineral tenement. Achieving the right balance between these concerns is not easy.

This is now particularly true, as the NNTT is facing a significant increase in its overall workload. The pressure has arisen because of recent judicial decisions affecting the administration of the right to negotiate process and the expedited procedure and because of a substantial increase in the lodgement of claims. To some extent, this pressure can be relieved by the devolution of workload relating to future acts to the States and Territories.

The Commission sees advantages in the States and Territories acting either to accelerate the establishment of their own future acts regimes under the NTA or, at least, amending their processes such that they are better coordinated with the right to negotiate process.

Section 21 agreements

The use of section 21 agreements to resolve native title concerns has been suggested by the NNTT as an alternative to the right to negotiate process (see, for example, French J 1995a). These are agreements between native title holders and governments to surrender native title or to authorise future acts. The agreements can be struck on a regional or local basis.

The NNTT has canvassed the use of section 21 to establish “framework” agreements as a basis for individual agreements (French J 1995b, p. 74). An example of a potential framework agreement is the Cape York agreement struck early this year among a number of peak bodies including the Cape York Land Council, ATSIC and the Cattlemen’s Union.[29] That agreement provides for a range of matters, including that Aboriginal groups not exercise any native title rights in a manner that would affect pastoralists. To be authorised under section 21 of the NTA, however, the agreement has to be ratified by the Commonwealth and Queensland Governments.

A number of observations can be made about section 21 agreements.

- First, they do not appear to be any different from normal contracts.
- Second, their effectiveness depends on ensuring that all interested parties are engaged in negotiations at an early stage. Otherwise, an agreement among some of the parties may need to be renegotiated to accommodate others.
- Third, it appears that, to be authorised under the NTA, the agreements may be struck only between native title holders and governments. However, the NNTT has argued that the parties can include claimants and beneficiaries of a future act such as mining companies (French J 1995c, pp. 16-17).
- Fourth, it is difficult to see how agreements struck between peak bodies (such as the Cape York agreement) can be used to ensure compliance by individual members.
- And fifth, like any agreement, they cannot be enforced against third parties.

Participants noted several problems with section 21 agreements. The NLC considered that they are difficult to enforce because of the need to obtain the signatures of most or all potential native title holders and to include “unwieldy” indemnity provisions (Sub. 31, p. 24). BHP noted that the right to negotiate process may apply even if agreements have been struck under the provision. It

[29] Other parties to the agreement were the Australian Conservation Foundation and The Wilderness Society.

also noted that the agreements cannot be initiated without government involvement.

The Native Title Amendment Bill contains several proposed amendments to clarify certain ambiguities associated with section 21. These include proposed amendments to make it clear that, where an agreement is with registered native title holders, acts affecting native title done under the agreement would be valid even though there is a later determination of native title to the area. Further, agreements authorised under the provision would be exempt from the right to negotiate process.

There are also proposed amendments which introduce a new process, an alternative to the right to negotiate process, for recognising agreements between registered claimants, governments and other parties about future acts (section 24A agreements). Like the right to negotiate process, this new process would involve notification and negotiation stages. However, there would be no prescribed time limits, no mandatory arbitration, and no provision for Ministerial over-ride. Future acts subjected to this new process would be valid, even if there were later determinations of native title. And later native title holders could be compensated by governments. These proposed amendments were introduced in recognition of the reluctance of parties to use section 21 in the absence of a formal determination of native title.

Options and implications

In the context of authorising future acts, section 21 agreements have the potential to offer a valuable alternative to the right to negotiate process. However, certain ambiguities and inflexibilities about the provision as well as issues about enforceability have reduced this potential.

Participants suggested several options to encourage the use of section 21. The NLC proposed a “voluntary agreement” process whereby agreements (such as its agreement with CRA at St Vidgeons) could be authorised under the NTA, without or in parallel to the future acts process. In conjunction, NTRBs would be given the power to “sign off” on behalf of potential native title holders with appropriate safeguards to ensure that these bodies performed their functions in this regard properly (Transcript, p. 41). The South Australian Government suggested that the provision be amended to provide “greater flexibility” and, in particular, to remove the need for agreements to refer to a particular future act (Sub. 45, p. 6). BHP suggested that the provision be amended to allow mining companies and claimants and native title holders to negotiate, irrespective of whether a claim has been lodged or determined or whether governments seek to become a party to negotiations.

To some extent, the proposed amendments contained in the Native Title Amendment Bill would address some of the problems associated with section 21 agreements (for example, ambiguities about whether the right to negotiate applies would be clarified). There also would be scope for agreements with registered claimants to be catered for under the NTA.

However, certain inflexibilities remain. For example, it is not clear why authorisation of the agreements should involve governments as parties in every case. Indeed, there may be claimants and native title holders who are willing to indemnify mining companies against the risk of later determinations of native title.

The Commission suggests that consideration be given to reviewing the requirement for governments to be parties to agreements under proposed amendments to section 21 as well as under the proposed new section 24A of the Native Title Amendment Bill.

Complexity of the NTA

The legislation is a complex document which is very difficult to read and understand. The drafting of the NTA has also been a point of criticism by members of the legal profession. For example, Russell (1995) said:

> The Native Title Act with its 253 sections must surely be one of the most convoluted and confusing pieces of legislation in the annals of parliamentary government. It is shot through with intensely bargained compromises. These have produced a tangled web of elaborately crafted clauses piling qualification on qualification and referring back and forth to one another in ways that are truly wonderous and virtually impenetrable to all but legal sophisticates (p. 70).

However, the Aboriginal and Torres Strait Islander Social Justice Commissioner noted that although “obviously complex”, with “patience”, the NTA is comprehensible (1995b, p. 21).

Participants suggested several reasons for the complexity. They include the pressure under which the NTA was drafted and the many amendments to the original Native Title Bill proposed by the Senate.

Several legal commentators provided additional reasons. Wootten (in Aboriginal and Torres Strait Islander Social Justice Commissioner 1995b) noted:

> One reason the Act comes across as complex and even baffling on a first reading is because of its extensive use of definitions. It is usually possible to get the drift of legislation without studying the definitions ... Much of the Native Title Act cannot be read like that. You sometimes learn more about what the Act is doing from the definitions than from what you expect to be the substantive provisions. Some of the definitions contain major statements of policy or process (p. 21).

However, the NLC rejected the view that the NTA was complex and convoluted and considered it to be easier to comprehend than taxation and companies legislation. It noted:

> The drafting problems of the NTA arise from the fact that it deals with difficult and complex concepts which are not capable of description by ordinary language. Consequently it is inevitable that the draftsperson has introduced an extensive list of definitions, and a complex structure, so as to ensure certainty in the operation of the act. Failure to take this approach would have resulted in unworkable legislation, and endless litigation (Sub. 31, p. 11).

The Commonwealth Government acknowledged recently the complexity of the NTA, but said that:

> ... [this] is not something that amendments can cure. To some extent, the problems experienced will be overcome with greater familiarity with the processes, the resolution of some of the outstanding legal issues and the passage of time (PM&C 1996, p. 10).

Options and implications

The complexity of the NTA can add unnecessarily to the resource costs of those who must use it; in particular, to Aboriginal and Torres Strait Islander peoples, mining companies and pastoralists. The convoluted structure of the legislation and the highly legalistic language of its provisions can contribute to uncertainties about the law. A particular concern is that uncertainties related to the complexity of the NTA could lead to unnecessary litigation in the courts.

The Aboriginal and Torres Strait Islander Social Justice Commissioner suggested measures to address the complexity of the NTA. First, that the Commonwealth Government review the language and structure of the NTA while maintaining its meaning and effect. And second, that the Commonwealth Government and peak bodies in the mining sector establish a comprehensive education campaign for the mining industry about the NTA procedures.

Although the Commission recognises that there are other aspects of the NTA that need prior attention, it considers that there should be a review of the legislation at a later time to address the complexity of its drafting. This review should involve examination by specialists of the legislation with a view to simplifying its language and structure. A good example of what can be achieved is legislation passed by the South Australian Government for the recognition of native title.

9 OTHER DOMESTIC POLICY INFLUENCES

The main government-related influences on offshore investment decisions — taxation issues, labour market regulation, environmental matters and land use regulations — have been discussed in earlier chapters. However, a number of other domestic policy influences were identified as contributing to location decisions. For example, one participant noted that the costs of achieving and maintaining Australian standards placed Australian-produced products at a competitive disadvantage in export markets. The Business Council of Australia noted that government taxes and charges on road transport increase significantly the cost of transport services. It said:

> ... the dominant sector of transport in terms of Australia's international competitiveness is road transport, where the largest government-related impediment is fuel excise (Sub. 22, p. 8).[1]

Other participants identified pharmaceutical benefits pricing policies and elements of the CER agreement with New Zealand as influencing their investment decisions. Among these other domestic policy influences, those mentioned most frequently by participants concerned transport issues and competition policy. These are discussed in turn in this chapter.

9.1 Transport issues

Efficient domestic and international transport play a crucial role in facilitating international trade. Poor quality or relatively high cost transport services can place Australian firms at a competitive disadvantage relative to their rivals in other countries. They may also contribute to a firm's decision to shift operations offshore. For example, the Minerals Council of Australia said that:

> Microeconomic reform of basic infrastructure sectors, such as transport and energy, can have a significant and positive impact on investment opportunities, tipping the balance on whether projects are able to proceed here in Australia, or whether they are lost to other countries (Sub. 24, p. 46).

The South Australian Government said that:

> Transport costs are an important element of location decisions for some types of manufacturing activity (Sub. 45, p. 6).

[1] Commonwealth and State government taxes on fuel were examined in the Commission's report on *Petroleum Products* (IC 1994). The Commission recommended that the Commonwealth initiate a review of taxes on intermediate inputs.

This section briefly discusses the current ‘state of play’ with respect to reforms within the transport sector. It notes some rail transport issues, but concentrates largely on the waterfront and coastal shipping, drawing on participants’ views and the BIE’s work on international benchmarking.

Rail freight

Railways are of particular importance for the mining and agricultural sectors. The bulk of public rail freight in Australia is handled by Queensland Rail and the State Rail Authority of New South Wales, which together account for three-quarters of all freight carried. Westrail, Australian National Rail and the Public Transport Corporation of Victoria handle the remainder.

The cost and performance of rail freight authorities were mentioned by some participants as imposing excessive costs on production. BHP said:

> All infrastructure costs are important determinants of investment, but transport costs in particular are a problem for Australia. For example, the Queensland rail freights have a severe impact on the economics of further development of coal properties in Queensland, particularly for the high growth energy coal market (Sub. 15, p. 13).

The Chamber of Mines and Energy of Western Australia said that Western Australia has lagged behind other States in introducing commercial reforms to government service providers. It noted that Westrail, despite a number of major changes, is still subject to only limited competition. It added:

> Westrail may be the best performing rail system in Australia but its operating costs would need to be reduced by 18% to match world’s best practice (BIE estimate) (Sub. 14, p. 5).

Although recognising that improvements in efficiency have been achieved, some participants raised concerns about the speed of reform. For example, the Minerals Council of Australia said:

> Rail transport reforms still remain an elusive target in a number of sectors ... While reforms are both promised and committed (by virtue of the introduction of the new National Competition Policy provisions), there has been no early moves to introduction or achievement of reform in this area.

It added:

> The five-year moratorium granted to Queensland (maintaining the monopoly market conditions to the year 2000) has caused an unhelpful delay in the timely introduction of a more competitive market-driven rail transport sector for the Australian export coal sector. The Hunter Valley coal rail access issue remains bogged down in bureaucratic processes and there is little prospect of early reforms being passed on to industry (Sub. 24, p. 48).

It is apparent that the performance of Australia's rail freight system is still well below world best practice. For instance, the BIE (1995h) reported that:

> ... in 1989–90 Australian systems as a whole had cost structures which were estimated as being 52 per cent above achievable best practice costs. This declined to 31 per cent in 1993–94. However, the extent of improvement varied considerably between systems (p. xvii).

Australian rail freight rates fell substantially in most States between 1991–92 and 1993–94. However, freight rates (with the exception of general freight rates) remain much higher than best practice overseas (BIE 1995h).

To improve performance and achieve world best practice, further reforms are required. One recent initiative has been the establishment of Track Australia, which aims to: place the line from Brisbane to Perth under single management control; separate control of the track from the train operators; and establish competitive neutrality in rail freight. Nonetheless, there is further scope for greater competition in the rail industry (and the transport industry more generally) by fully implementing reforms arising from the Hilmer report and initiatives identified by the Council of Australian Governments. The reforms, some of which have already been implemented, involve:

- extending Part IV of the Trade Practices Act to all State rail authorities;
- establishing a legal right to negotiate access to rail infrastructure on commercial terms, where an effective access regime is not in place;
- ensuring competitive neutrality between public rail authorities and competing private sector businesses;
- applying the Prices Surveillance Act to those State rail authorities not subject to effective price oversight arrangements; and
- removing statutory monopolies with respect to the transport of some commodities (IC 1995a, pp. 189-90).

In its recent *Stocktake* report, the Productivity Commission (1996) said that, in progressing reforms, governments should give priority to direct funding of community service obligations and that rail management should seek further savings in areas such as corporate overheads, rolling stock maintenance and signalling control. Application of these and other reforms mentioned above is particularly important in areas such as coal freight, where freight rates are well in excess of world best practice.

Waterfront and shipping

Most of Australia's exports and imports are carried by ship. Consequently, the efficiency of waterfront and shipping services is an important determinant of the international competitiveness of Australian producers. For those products for which both exporting and offshore production are possible, inefficient or unduly expensive transport services may in some cases induce a firm to go offshore when it might not otherwise have done so.

The cost and efficiency of waterfront and shipping services were identified by several participants as factors impeding the competitiveness of Australian industry. For example, AEEMA said:

> The waterfront remains an area of considerable concern for Australia's electrical and electronic industries. Delays in shipping seriously undermine Australia's competitiveness and have been cited as an important reason by one survey respondent for establishing manufacturing operations offshore (Sub. 16, p. 4).

The MTIA said that problems experienced by its members included:

> ... excessive wharf costs ... excessive turnaround times; unplanned capacity; stoppages; demarcation; lack of flexibility; and cost of shipping across the Tasman (Sub. 9, p. 7).

It added that 40 per cent of companies in its survey indicated that the cost and inefficiencies of Australian shipping were "an inducement" to produce offshore, rather than export from Australia. Similarly, CRA said:

> Coastal shipping is important to mining operations both as an essential part of the transportation network and as a significant cost item and which is still partly insulated from the cost-cutting characterising the other links in the production/marketing chain. For instance in the establishment of any alumina plant at Weipa, the freight charges on coal from Queensland will be 50% more expensive than if sourced from Indonesia (Sub. 13, p. 18).

The maintenance of cabotage was also raised by some participants. For example, the Minerals Council of Australia noted that, while major cost savings have been achieved in domestic shipping through reduced crewing costs:

> Other restrictions ... exist in terms of the lack of opportunity to access international flag vessels to undertake coastal voyages (due to the licensing requirements for vessels under the Australian Navigation Act) ... (Sub. 24, p. 48).

There have been gains

Over the past decade or so, there has been progress in improving the performance of waterfront activities. The reform process has focused on stevedoring and port authority activities, with the aim of improving productivity and timeliness, and reducing costs. Coastal shipping has also been the subject of reforms since the early 1980s.

Reforms in the stevedoring sector have concentrated largely on industrial relations issues. Progress was coordinated and monitored by the Waterfront Industry Reform Authority (WIRA), which operated from 1989 to 1992. The formal stevedoring reform program was completed in October 1992, at which stage enterprise employment had replaced industry-based arrangements and major performance improvements had been obtained (see Box 9.1).

According to WIRA (1992), higher productivity (in the form of lower charges and faster turnaround times) has resulted in savings of at least $300 million per annum.

The Bureau of Transport and Communications Economics (BTCE) estimated that waterfront reforms benefited shippers to the extent of about $276 million in 1993. Of this, about $267 million went to shippers of non-bulk cargoes and $9 million to shippers of bulk cargo. Australians captured a large proportion of these gains (BTCE 1995, p. xxiv).

Reform of the port authorities has focused on administrative and structural arrangements, such as the shedding of non-core activities and a move towards a landlord function. This is consistent with the recommendations of a report by the Industry Commission (IC 1993b).

Coastal shipping reforms have provided significant improvements through reduced crew levels, better training, more flexibility in the use of crew and investment in technologically advanced vessels. The BIE (1995b) found that:

> Reform initiatives from the mid 1980s to around 1993 have yielded substantial improvements, particularly in reducing crewing levels, improving crewing skills and flexibility and encouraging investment in technologically advanced vessels (p. 12).

Scope for further improvements

Notwithstanding the gains generated to date, there is evidence that the momentum for reform has slowed, and in some areas productivity has declined. The BIE (1995g, pp. 57-8) reported that, over the past year, there have been some serious setbacks in crane rates (containers moved per crane hour), and recent declines in container stevedoring productivity have resulted in the performance of Australian ports falling well behind similar ports overseas. It also noted that Australia's performance in break-bulk[2] services urgently needs improving.

Box 9.1: Reported benefits of maritime reform up to 1994

Stevedoring reform

A three year stevedoring WIRA program concluding in October 1992 resulted in:

- a 57 per cent reduction in the stevedoring workforce;
- a 127 per cent increase in the numbers of containers handled by a man-shift;
- a 25 per cent reduction in container terminal charges;
- an increase in container handling rates from under 13 twenty-foot equivalent units (teu) per hour to about 20 teu per hour; and
- a 45 per cent reduction in ship turn-around time.

Towage reform

Improvements in towage include:

- a reduction in crew size from up to 8 down to 4, between 1989 and 1994; and
- annual savings of up to $480 000 per tug.

Grain handling reform

Improved productivity of grain handling has enabled savings of $35 million per annum:

- average loading times dropped from 4.5 days in 1988 to 1.9 days at June 1992; and
- manning reductions of between 50 and 80 per cent were accompanied by cost reductions of around 50 per cent over the same period.

Port authority reform

State governments have corporatised port authorities to improve performance:

- since 1988, port authority workforces have been reduced by more than 40 per cent; and
- port authorities have substantially improved their financial performance and, overall, now make a reasonable return on their assets.

Source: BIE 1995d, p. 29, drawing on NTPT 1994, BTCE 1995 and WIRA 1992.

Similarly, the BTCE (1995) reported that there were indications of a recent drop in stevedoring performance to levels below that achieved in 1992. It found that the performance of the stevedoring industry was influenced, in part, by restrictions on access to labour and inflexible work practices. The BTCE (1995) said that:

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2 This refers to non-bulk cargo that is not containerised. Examples include assembled cars, steel coil and pallets of timber.

> In early 1994 idle time levels, high levels of overtime and low levels of casual employment indicated labour flexibility was far from ideal (p. xx).

It noted that there was scope for improved labour flexibility which would allow reduced idle time and overtime payments, as well as increased employment opportunities in stevedoring. It also observed that constraints on the use of casual labour add to stevedoring costs:

> Under the present roster arrangements, casual labour is only used as a last resort, with overtime and double headers being worked before casuals can be employed (p. xx).

The BIE (1995d, p. 73) found that 80 per cent of ship companies surveyed considered that “turnaround times have improved faster overseas than in Australia over the last five years” and that the gap between Australian and overseas ports has widened. Respondents also considered that the service standards of pilot and tug operations and port authority and government services were poor.

The Commission found in discussions with a range of firms in New Zealand that waterfront reforms in that country have resulted in significant improvements, such as reduced stevedoring charges and freight rates and that, on average, turnaround times are considerably faster in New Zealand than in Australia. This is supported by a study by Bancorp Holdings (1993) which found that:

> ... Container ships have improved efficiency and now turn around in under 16 hours against a 38 hour average pre-1988, with other ships turning around in 1.5 days instead of 3.4 days. By contrast Australia’s turnaround time is approximately five days (p. 16).

The New Zealand Government adopted a two-stage approach to waterfront reform. This involved commercialising port authorities and “changing the attitude and structure of the labour force to promote competition within and between ports” (BIE 1995d, p. 112). The BIE found that, compared with Australia’s waterfront reform process, “the New Zealand Government implemented their reforms at a faster pace and took their reforms further”. It noted that “the benefits reaped by the New Zealand economy have been consistently sustained since the reforms were implemented” (p. 117).

In the BIE’s view, container handling in Australia needs to be improved “markedly” for it to perform as well as comparable overseas ports (p. xiii):

> ... waterfront charges for containers are considerably higher in Australia than at a range of ports in south east Asia, Europe and New Zealand. They are, however,

> not the highest in the world. Waterfront charges in Australia are on a par with those at Wellington and Hong Kong. They are consistently below the three American ports of Oakland, Baltimore and Charleston (p. 72).

For break-bulk cargo, the BIE relied on benchmarking studies carried out by BHP Transport. According to those studies, Australian industry still lags behind world best practice, despite the reforms in the stevedoring industry:

> ... Australia's non-terminal charges and stevedoring costs are high by international standards. Port authority and ancillary charges are the main cause of the differences between Australian and overseas non-terminal break-bulk charges (p. 90).

The Commonwealth Government has announced several policy changes — for example, to labour market arrangements and the ownership and regulation of ports — which it expects will lead greater competition and flexibility, and consequent benefits to users (Sharp 1996).

Coastal shipping also has undergone a process of reform. A recent survey of Australian coastal shipping users undertaken by the BIE found that, while most bulk and non-bulk users were satisfied with the level of service they were receiving, rating reliability of delivery time and care of goods highly, they were not satisfied with the rates and prices and, to a lesser extent, the wharfside interface. The BIE (1995b) reported that:

> ... the reform process over the last year or so has yielded only limited additional benefits (p. 12).

And that:

> Australia's overall vessel costs are comparatively high. They are well above those in South Korea, the UK, Germany and Norway, somewhat above New Zealand but below the USA and Japan (p. x).

The efficiency of coastal shipping services continues to be impeded by the cabotage policy, which prohibits foreign ships from serving domestic coastal routes. The Minister for Transport said that the Government is "committed to ending the closed market in domestic shipping by winding back cabotage in consultation with industry representatives" (Sharp 1996, p. 6).

Concluding comments

The reforms introduced on the waterfront and to coastal shipping services in the late 1980s and early 1990s generated some benefits for Australia. However, recent evidence shows that the impetus of reform has not been maintained and, as a result, performance has declined. Australia continues to lag behind world best practice.

On the waterfront, there is scope for further gains from reforms, particularly by increasing flexibility in the labour market, where there are still considerable constraints on, for example, the type of labour used and the hours worked. Enactment of the Commonwealth's proposed labour market reforms will open the wharves to non-union labour and/or allowing competing unions, and end the preference for union labour in cleaning ships (see Productivity Commission 1996).

Further benefits can be achieved from enhanced competition in stevedoring services. This might involve, for example, encouraging new stevedoring operators or fixed-term franchises for stevedores. In the *Stocktake* report, it was recommended that State and Territory governments should facilitate greater contestability in stevedoring services and that a review be conducted to determine how best to make such services more contestable.

For coastal shipping, the main cause of Australia's uncompetitive cost position is high crew costs, due mainly to high leave and wage on-costs. A number of independent studies have concluded that increasing the exposure of coastal shipping to international competition by removal of cabotage is the key to achieving sustained improvements in productivity and competitiveness. The Commission's *Stocktake* report proposed that the Commonwealth extend the single voyage permit system to allow vessels on international voyages to carry cargo between Australian ports for, say, up to a month, and that no restrictions apply to foreign vessels crewed by Australian seamen servicing coastal routes.

Renewed efforts to raise productivity and reduce unit costs would also help to ensure more efficient decisions about the location of new investment.

9.2 Competition policy

Over the last few years, competition policy has become a major part of government initiatives to improve the efficiency of the economy and promote growth. Some significant new policy measures have been introduced — such as the National Competition Policy Reform package — and a new institutional framework has been established to implement competition policy. The main purpose of these initiatives has been to bring greater competitive pressure to bear on government enterprises and to parts of the economy which had previously been exempt from trade practices regulations.

These initiatives were preceded by changes to the Trade Practices Act to prevent mergers which "substantially lessen competition in a substantial market”.[3] The previous test had simply been aimed at preventing the emergence of “dominant” firms.

During its visits, the Commission heard from a number of major Australian offshore investors — in finance, construction materials and other areas of manufacturing — that they had little alternative to offshore investment if they wanted to grow significantly, as the new trade practices regulation effectively precluded domestic expansion through mergers and acquisitions. They saw this as unnecessarily impairing the efficiency of Australian industry.

For instance, Pioneer stated:

> Pioneer’s ability to expand in Australia is seriously restricted by the Trade Practices Act, which is currently administered to make it virtually impossible for a large company like Pioneer to increase its market share significantly. Such restraint also inhibits Pioneer from achieving world competitiveness and optimum efficiency and costs in Australia ... If the number of major Australian building materials companies were reduced from three to two (by merger or takeover) the global competitiveness of the remaining two companies would be substantially improved. The building materials industry in Australia would be considerably more efficient and lower cost, to the benefit of the Australian economy (Sub. 4, pp. 3-4).

And the MTIA said:

> ... Part IV of the Trade Practices Act, by its concentrated focus on prohibiting conduct that is likely to substantially lessen competition on the domestic front, runs the very real risk of becoming an impediment to the necessary aggregation of Australian capability in order to become a viable force not only in our domestic market but also in world markets (Sub. 9, p. 29).

These concerns were also reflected in the Commission’s survey results, in which a significant proportion of respondents identified merger regulation as the most important Australian Government influence on their decision to locate abroad. The BIE survey reported a similar finding.

Rationale for prohibiting ‘anti-competitive’ mergers

The rationale for government regulation of mergers and takeovers reflects the likelihood that some mergers, if permitted to proceed, would be contrary to the interests of the broader community. More specifically, some mergers could result in the new entity having significant market power — that is, the ability to raise prices substantially above competitive levels over a prolonged period of time and earn ‘excess profits’.

The exercise of market power can impose costs on the community through:

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3 These changes came into effect from 21 January 1993.

- *allocative inefficiencies* that arise when prices do not reflect supply costs, causing users to forgo consumption;
- *productive inefficiencies* that occur when costs are higher than they would be in a competitive market; and
- *dynamic inefficiencies* that can arise through reduced incentives to respond to changes in market conditions, and to make sound and timely investment decisions.

Certain factors — such as regulation (for instance, price surveillance), the threat of regulation or political pressure — could moderate the exercise, and hence the costs, of a firm using market power. However, these factors are seldom likely to eliminate the possibility of a firm with market power exploiting it to some extent.

The most efficient way of overcoming the problems associated with market power is to address the *cause* of the problem. One way of doing this is by preventing anti-competitive mergers and acquisitions. However, this is not a straightforward task because, first, it is difficult to assess whether the merged firm would have significant market power and, second, there is a need to avoid inhibiting mergers which enhance efficiency to the point where the community would be better off despite some increase in market power. Hence, the current policy will be effective only if, in the administration of that policy, it is possible to identify anti-competitive mergers without deterring desirable efficiency-enhancing mergers.

The broad parameters underlying the administration of mergers law are outlined in Merger Guidelines issued by the Australian Competition and Consumer Commission (ACCC).

Merger guidelines

The ACCC (1996a) released revised Merger Guidelines in July 1996. These updated the Draft Merger Guidelines issued in November 1992 by the then Trade Practices Commission, in anticipation of amendments to the Trade Practices Act to replace the ‘dominance’ test with a ‘competition’ test for regulating mergers. In brief, the ACCC will oppose mergers that are found to “substantially lessen competition in a substantial market”, unless “authorised” by the ACCC as providing net public benefits. The Merger Guidelines provide information on the approach adopted by the ACCC in assessing merger proposals.

The Merger Guidelines illustrate how statutory ‘merger factors’ (factors to which the ACCC must have regard under the Act, such as industry concentration, the level of import competition and the availability of substitute products) are incorporated into a five-stage evaluation process. The five stages comprise:

- defining the market;
- calculating market shares and seller concentration ratios as enforcement thresholds;
- assessing import competition;
- assessing barriers to entry (for example, sunk costs and legal or regulatory barriers); and
- considering any other relevant factors.

The evaluation process is intended to screen out mergers that would not substantially lessen competition. The ACCC investigates proposed mergers only if they would result in the four largest firms supplying 75 per cent or more of the relevant market (and the merged firm having at least 15 per cent), or the merged firm having a market share of 40 per cent or more. The ACCC will oppose those mergers not falling within the 'safe harbour' created by the market share thresholds only if they fail all other steps in the evaluation process.

The ACCC can agree to a merger (or acquisition) proposal that would otherwise be considered anti-competitive if 'enforceable undertakings' are provided by the parties that address the ACCC's competitive concerns. Typically, such undertakings involve structural constraints on the entity (such as a restriction on future acquisitions or a post-merger divestiture obligation), although restraints on conduct (such as price or access agreements) are sometimes used.

In 1993–94, the first full year of the new competition test, the TPC considered 132 mergers — compared with 86 in the previous year — and formally objected to six. In 1994–95, the TPC had 151 mergers referred to it, and formally objected to eight. In 1995–96, the ACCC examined 140 mergers (of which 52 exceeded the threshold levels), and opposed six.

Improving the effectiveness of merger policy

Most mergers and acquisitions have the potential to enhance efficiency. They can allow the merged entity to take advantage of economies of scale and scope that would not otherwise be available to the individual firms. They can be a means of introducing significant improvements in structure and management. And they can have a positive affect on dynamic efficiency by providing the impetus required to innovate, to develop more efficient ways of doing business and to better meet users' needs. The threat of takeover imposes an added discipline on managerial performance. On the other hand, as noted above, some mergers may provide the merged firm with significant market power and have adverse efficiency implications.

In these circumstances, it is crucial that merger policy be administered in a way that permits mergers which improve efficiency and promote the interests of the broader community to be distinguished from those which may be anti-competitive and contrary to the public interest. If the administration of the policy is too ‘loose’, opportunities will arise for merged firms to engage in anti-competitive practices. Conversely, an approach which is unduly restrictive and subjects too many firms to merger scrutiny could create excessive uncertainty, impede necessary business restructuring and rationalisation, and lead to investment taking place offshore, rather than achieving higher social returns domestically. Although the current legislation enables the ACCC to authorise anti-competitive mergers that are judged to provide net public benefits, relatively few merger proposals have received such ‘authorisation’.

In practice, it is clearly difficult to determine where to draw the line so as to contain the economic costs of anti-competitive mergers, while at the same time not deterring efficiency-enhancing mergers. In a recent information paper, *Merger Regulation* (IC 1996), the Commission expressed concerns that the application of the (then) Draft Guidelines was resulting in an overly restrictive regulatory policy that risked preventing or deterring efficiency-enhancing mergers. It made several proposals aimed at improving their transparency and reducing their restrictiveness, while still meeting the legislative requirements of safeguarding competitive markets. These issues were foreshadowed in the Commission’s draft report for this inquiry.

Coopers and Lybrand agreed, in response to the draft report, that the ACCC should adopt a less restrictive approach to mergers, and be more mindful of the economic efficiency considerations of mergers:

> ... problems do not necessarily exist with the s50 Trade Practices Act ... requirements themselves (such as substantial lessening of competition). Rather, problems are more likely to arise from the way in which the ACCC interprets and administers such requirements (Sub. 37, p. 3).

A number of the Commission’s specific concerns were addressed in the ACCC’s revised Merger Guidelines. In other areas where the Commission raised more general concerns, few, if any, changes were made (and the likely practical significance of some of the changes that were made is difficult to assess at this stage). While the revised Guidelines are important in themselves, it is their interpretation and application by the ACCC that ultimately will determine their impact.

Market definition

Proper understanding and definition of the markets in which firms operate is crucial to making sensible decisions about the market power implications of mergers or takeovers. Depending on how markets are defined, market power may be found to be pervasive or non-existent.

The Guidelines provide an indicative list of factors which the ACCC may consider when establishing the relevant product, geographical and functional dimensions of the market. These include: the end-use of the product and potential substitutes; the costs of switching between the current product and potential substitutes; the perishability of the product; transportation costs; and customers' convenience of gaining access to alternative sources of supply. The Guidelines also refer to the possible role of sub-markets for merger evaluation purposes, as a means of identifying market segments with some discontinuity in substitution possibilities or special characteristics.

The revised Guidelines contain expanded discussion on how markets will be defined by the ACCC. Although improved in certain respects, they remain indicative. This partly reflects the judgments necessary in setting market boundaries. For example, the time dimension — the period over which substitution possibilities should be considered in defining markets — although now directly included, is defined as "over the longer term, but still in the foreseeable future".

Notwithstanding the expanded discussion in the revised Guidelines, in practice, the ACCC can reserve its judgment on market definition until it receives full details from the parties to the merger proposal. Thus, firms are required to prepare and submit merger proposals to the ACCC without knowing how their market will be defined.

In this inquiry, representatives of a number of large companies, notably the major banks, expressed concern that the markets for their services were being defined far too narrowly. Some participants from the banking sector cited the TPC's reasoning in relation to the Westpac takeover of Challenge Bank in Western Australia as implying:

- a distinct market for services offered by banks — when banks see themselves in competition with a range of non-bank financial institutions; and
- a market defined by State borders — when banks see their markets as national and, in some activities, international in scope.

However, the St George Bank disputed the views of the major banks, and argued for further analysis and debate before changes are made to the definition of the market for banking services. It said that banks have certain distinctive features which most non-bank financial institutions find difficult to match, and argued that competitive pressures:

> ... have traditionally been created by rivalry between banks, especially between the major banks and ... banks like St George and single product providers like mortgage lenders (Sub. 49, pp. 2-3).

In addition:

> ... the retail banking market is domestic, not global, in scope, and has no short-term prospect of internationalisation ... Brand recognition and consumers' preference to bank locally ... clearly supports the notion that the market for banking services is state-based. This view is consistent with the TPC's decision in the Westpac/Challenge merger in 1995 (Sub. 49, pp. 3-4).

The St George Bank recognised that technology is quickly transforming the financial services sector, but argued that, while banks have increasing capacity to provide electronic facilities, there is some unwillingness by consumers and businesses to abandon traditional branch banking. Nevertheless, it is apparent that technological change has heightened the substitution possibilities within the financial sector and across regional boundaries. As the Deputy Governor of the Reserve Bank has observed:

> Technological innovations are rendering obsolete judgments about market competitiveness which are based on numbers of branches in a particular geographic area, or even existing market shares for deposits or loans. This is because the new delivery systems are making regional markets more readily contestable by institutions — whether banks or others — without a strong physical presence in those areas (Thompson 1996, p. 6).

The revised Merger Guidelines appear to provide for the possibility of the ACCC adopting broader market definitions in sectors undergoing deregulation. For example, the Guidelines note that "changes in the licensing arrangements for financial institutions may result in greater supply side substitution and broader product markets" (ACCC 1996a, p. 8).

Competition in the banking sector falls within the terms of reference of the current Wallis inquiry into the financial system. That inquiry will assess the results of financial deregulation of the financial system since the early 1980s, and analyse the forces driving further change. The inquiry, which was announced after the release of the Commission's draft report, is due to report in March 1997.

In the Commission's view, a reassessment by the ACCC of the markets in which banks now operate is justified. This is best undertaken in the light of the results of the Wallis inquiry.

Market definition plays a crucial role in the application of the legislation and the Guidelines enunciated by the ACCC. In view of this, there would be benefits in the ACCC making more transparent the criteria and reasoning used in delineating the relevant market. Although market definition in many proposals will be relatively straightforward, occasions will arise when this will not be the case, especially in service markets such as finance, telecommunications and energy. **In more difficult cases, there would be benefit in the ACCC publishing detailed studies to illustrate how market definition was determined, particularly in service industries and markets characterised by strong product differentiation.**

Market share and concentration thresholds

As noted, the ACCC's Guidelines define a 'safe harbour' for firms having low market shares or competing in markets where concentration is relatively low. The thresholds reflect ACCC judgments based on its assessment of particular industries that it would want to scrutinise. They have been set a little higher than the thresholds for United States and Canadian antitrust regulation, partly to take into account Australia's smaller market.

The Commission supports the use of 'safe harbours' as a useful way of reducing uncertainty for firms in situations in which market power concerns are unlikely. Indeed, this was the logic behind the original 'dominance test' in the Trade Practices Act, which provided a simple rule-of-thumb that any mergers which did not leave a dominant firm in the market were not worth investigating, on the presumption that the costs of having a wider 'net' outweighed the benefits.

The current provisions of the Act preclude such an approach, but scope remains to choose different concentration thresholds, depending on judgments about the point at which concerns over possible substantial market power begin to be justified.

Overseas studies suggest that such concerns may begin at market share levels somewhat higher than those currently employed. Under the existing thresholds, mergers can be subject to scrutiny even when five or six significant competitors would remain in the market. Given the resulting large number of proposals being scrutinised, compared with the small number of objections, the Commission has suggested that the ACCC should consider the implications of raising the thresholds.

The Commission proposed that the threshold market share for an individual merged firm be raised from 40 to 50 per cent; and that the post-merger four-firm concentration ratio of 75 per cent be replaced with a *three*-firm ratio of 75 per cent, and be operative when the merged firm has at least 20

per cent, instead of 15 per cent, of the market. This issue is discussed further in the Commission's information paper.

In releasing its revised Guidelines, the ACCC announced that it would review the appropriateness of existing thresholds. All mergers in 1996–97 will be reviewed by the ACCC against both the current threshold levels and those proposed by the Commission to see whether competition concerns are raised. The results will be published by the ACCC.

Import threshold

The Draft Guidelines recognised the important role that imports, or potential imports, can play in promoting competition. Indeed, the effectiveness of import competition has always been the first factor assessed for merger proposals that fall outside the 'safe harbour' determined by the market share and concentration thresholds.

Nevertheless, bearing in mind the increasing competitive pressure from imports brought about by falling tariffs, the Commission proposed designating a threshold level for import competition of 10 per cent, with higher levels leading to the presumption that the proposed merger would not be anti-competitive. This was adopted by the ACCC as an 'indicative' guideline. It is unlikely to oppose mergers where "comparable and competitive imports" have sustained a market share of at least 10 per cent over three years. To be 'competitive', imports presumably would need to be 'arms length' and not subject to special quantitative restrictions.

Assessing barriers to entry

The existence of barriers to entry remains the key to determining whether mergers and acquisitions in markets that are highly concentrated and have limited import competition pose a significant anti-competitive threat.

The Guidelines define a barrier to entry as any feature of a market that places an efficient prospective entrant at a significant disadvantage relative to the incumbent firms. According to the Guidelines, barriers to entry may consist of: sunk costs; legal or regulatory barriers; access to scarce resources enjoyed by incumbent firms; economies of scale and scope; product differentiation and brand loyalty; and the threat of retaliatory action by incumbents.

The Guidelines require firms to demonstrate that there is scope for "effective entry", namely that:

> ... which is likely to have a market impact within a two year period; either by deterring or defeating the attempted exercise of significant market power by the merged firm. In some markets the threat of entry is sufficient to constrain firm

> conduct. In others, actual entry will be required. The latter would require entry on a sufficient scale and which offered a product sufficiently attractive to consumers to be effective (ACCC 1996a, p. 49).

Although the measures identified in the Guidelines as possible entry barriers have been regarded as such by many, a significant body of economic literature suggests that, on closer examination, most do not in themselves constitute entry barriers in the absence of sunk costs. Sunk costs are those costs which, once incurred, cannot be recovered if the venture fails. While such costs need to be incurred by incumbents as well as entrants, they place the entrant at a disadvantage: the incumbent, unlike the entrant, does not have to factor them into pricing decisions.

While the revised Guidelines recognise the importance of sunk costs, the Commission considers that they do not place sufficient weight on the need for a sunk cost component to be present in the list of other factors regarded as barriers to entry.

It is important in assessing ease of entry to an industry to consider how long it would take for new entry to occur. The Commission reiterates its view that regarding entry as effective if it occurs within two years may be too short a period in many industries. Given the considerable time lags associated with most large investments, such a period may not give the market sufficient time to work. The Commission has suggested that a period of five years may be more appropriate (IC 1996).

Efficiency considerations

The Commission was concerned that under the Draft Guidelines, the efficiency effects of mergers were dealt with only within the public benefit authorisation procedures, which were rarely used. In the Commission's view, public benefit was not only poorly defined within the Act (including factors such as the substitution of domestic production for imports), but its interpretation by the ACCC was unclear and appeared to discount benefits to producers which could yield welfare gains without necessarily reducing consumer prices. The revised Guidelines continue to place emphasis on price reductions, but also give more attention to other sources of efficiency gains:

> For example, a merger may result in economies of scale or other resource savings which may not be immediately available to consumers in lower prices. However, the community at large has an interest in resource savings, releasing those resources for use elsewhere (ACCC 1996a, p. 68).

Moreover, in contrast to the previous arrangements, the revised Guidelines make some provision for the efficiency effects of mergers and takeovers to be considered directly in the competition test:

> Where a merger enhances the efficiency of the merged firm, for example by achieving economies of scale or effectively combining research and development facilities, it may have the effect of creating a new or enhanced competitive constraint on the unilateral conduct of other firms in the market or it may undermine the conditions for collusive conduct.
>
> If such efficiencies are likely to result in lower (or not significantly higher) prices, increased output and/or higher quality goods or services, the merger may well not substantially lessen competition (ACCC 1996b, p. 14).

These changes provide greater scope to take the efficiency effects of mergers into account than under the Draft Guidelines. The extent of their applicability is unclear, however, and will depend partly on how the provisions are interpreted in practice.

10 FOREIGN GOVERNMENT MEASURES AFFECTING ADIA

10.1 Introduction

Offshore investment enables Australian firms to raise or maintain their international competitiveness. As shown in Chapter 4, it can have a positive effect on national income and on the wealth of the Australian community. It is clearly in Australia's economic interests for foreign governments to remove or relax restrictions impeding ADIA.

Over recent years, there has been increased investment by Australian firms in the Asia-Pacific region. This reflects both increased opportunities in these economies and the lowering — albeit somewhat unevenly — of barriers to investment. APEC economies as a group now account for over half of the stock of ADIA. In view of the growing importance of that region to Australia, this chapter focuses on identifying the main policy measures within APEC which affect ADIA.

APEC comprises a range of developing and developed economies which have divergent policies on foreign investment. As already noted, most of these countries have made significant headway recently in liberalising their investment regimes, although in some cases from a highly restricted base. In addition, investment regimes within the region are now more transparent — due largely to the ongoing work within the APEC forum on trade and investment facilitation (see Box 10.1). Nonetheless, some APEC members — particularly in Asia — still maintain substantial impediments to inward foreign investment.

Several firms visited during this inquiry stated that they often encountered foreign investment restrictions in other countries, and that these had influenced their investment decisions. Although the Commission's survey did not seek detail on foreign impediments to ADIA, around one-fifth of all respondents indicated that they had encountered foreign government restrictions on repatriation of profits to Australia. Furthermore, over one-quarter of respondents identified tax incentives as the main factor subject to foreign government control that influenced their decision to invest overseas.

Box 10.1: APEC

Asia-Pacific Economic Cooperation (APEC) currently comprises Australia and seventeen other Asia-Pacific economies. Under the 1994 Bogor Declaration and the 1995 Osaka Action Agenda, APEC members have committed themselves to the goal of free and open trade and investment in the Asia-Pacific by 2010 for industrial economies and 2020 for developing countries.

Within APEC, several committees have been formed, such as the Committee on Trade and Investment, to undertake work relevant to trade and investment. An important input to APEC is provided by the Pacific Economic Cooperation Council (PECC), a non-governmental body comprising business, government and research representatives, which has observer status within APEC.

A recent APEC commissioned study by PECC (1995a) — the *Survey of Impediments to Trade and Investment in the APEC Region* — has been drawn on extensively in this chapter. This report, prepared for the APEC Osaka meeting last November, was the first comprehensive attempt to document barriers to trade and investment within the region. It was conducted by PECC at the request of the APEC Committee on Trade and Investment. The report concluded that investment flows within APEC continue to be distorted by lack of market access and national treatment, and the frequent use of investment incentives.

10.2 Measures affecting foreign investment

Investment measures can take diverse forms:

- Restrictions on foreign investment include foreign ownership limits and divestment requirements, as well as various trade-related investment measures, such as local content provisions and other performance requirements (for example, minimum export targets).
- Investment incentives include subsidies, tariffs and tax exemptions on inputs, as well as concessional provision of infrastructure and various forms of income tax concessions.

Such measures are often complex and non-transparent, and variable across industries when they target certain sectors. Furthermore, investment regimes usually contain a mix of measures which both encourage and restrict inward foreign investment. This makes it difficult to assess the overall restrictiveness of a country’s investment regime.

Foreign investment restrictions can affect all sectors. Most countries restrict, to varying degrees, foreign investment in service industries (for example, maximum limits on foreign equity and restrictions on the use of foreign personnel). Commercial presence in overseas markets through foreign direct investment is an important means of trading services globally — over 60 per cent of such investment is in services provision. Since most services require, or are better supplied through, a commercial presence in the overseas market, foreign investment restrictions can substantially impede international trade in services.

Identifying investment measures

A useful framework for identifying investment measures is to classify them according to whether they violate the key liberalisation principles of *right of establishment* (also called *market access* or *commercial presence*) and *national treatment*.[1] Some measures violate both right of establishment and national treatment.[2] It is also important that investment measures be transparent. Non-transparent administrative requirements, such as vague and ambiguous guidelines, are likely to hinder foreign investors more than domestic investors.

Since most investment incentives are either provided equally to domestic and foreign investors or discriminate in favour of foreign investment, they are usually consistent with both of these principles. Consequently investment incentives are classified separately.

The following discussion illustrates the nature and diversity of measures maintained by APEC economies to restrict foreign investment in manufacturing. It is not intended to be an exhaustive list of such investment measures, nor does it cover restrictions in other sectors, such as services.

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1 Although the two concepts are closely related, this chapter follows OECD practice and treats them separately. *Right of establishment* covers measures that are applied up to when the foreign investor is established in the home market. *National treatment* refers to those measures operating post-establishment.

2 Measures restricting foreign investment can also be distinguished by whether they are applied on an MFN (most-favoured-nation) basis — thereby providing most favourable treatment to all other countries — or discriminate by extending such treatment only to selected countries (called conditional MFN). Liberalising foreign investment regimes on an MFN basis, whereby all overseas investors receive the same treatment irrespective of country of source, is economically superior to conditional MFN as it avoids possible investment diversion (see Section 10.5).

Right of establishment

Providing foreign investors the unconditional right of commercial presence in the host market on grounds no less favourable than domestic investors would require screening or approval procedures for foreign and domestic investment to be comparable.

Partial restrictions on entry and establishment, aimed at limiting inward foreign investment or influencing its sectoral allocation, are the hallmark of most regulated foreign investment regimes. They are often justified on the grounds of protecting national security or promoting the national interest. In practice, they are used frequently to restrict investment in order to protect domestic industries from foreign competition. Controls on private ownership — for example, to maintain public sector monopolies — would satisfy the principle of right of establishment provided domestic and foreign private investors were treated equally.

A number of inquiry participants commented that ownership restrictions and joint venture requirements were the main policy obstacles encountered overseas, especially in Asian countries. Foreign equity limits in some Asian countries are set at below 50 per cent. Some firms indicated that they would like to raise their foreign ownership levels above the existing limits. However, several other firms suggested that they would have engaged a joint venture domestic partner in any event to improve the project's chances of success.

Ownership restrictions are usually specified on an industry basis, with different limits applying to different industries. Foreign investment in some sectors is banned. In some Asian countries, restrictions on foreign ownership limit participation of overseas investors in privatisation programs.[3] Many Asian countries also frequently require that foreign investment in designated industries be conditional on specified targets being met, or that it be limited to certain regions.

Authorisation, approval and licensing procedures often involve unclear, duplicative and cumbersome arrangements for screening, notifying and registering foreign projects. Many layers of approval and authorisation can be required, often involving a number of national and sub-national governmental

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3 Industries subject to ownership controls are usually specified in either a 'positive' list which contains all non-restricted industries or a 'negative' list specifying all restricted industries. A 'negative' list facilitates foreign investment by being more transparent and certain. Under these arrangements, all new investment opportunities, for example, would be automatically open to foreign investment.

agencies.[4] Such requirements can result in major, and uncertain, implementation delays, and add substantially to investment costs.

Divestiture provisions which require a certain level of foreign equity to be acquired by local interests within a specified period are used frequently. These permit higher foreign participation at the outset, but generally require foreign investors to reduce their equity to 50 per cent or below within 5 to 10 years.

National treatment

National treatment requires foreign investors to be treated no less favourably than domestic investors *following establishment in the host market*. This includes their operations under investment laws, regulations, rules and administrative procedures. Ideally, it would also extend to cover the same access and legal protection in areas such as taxation, labour, consumer rights, environment, government procurement, repatriation (transfer of funds overseas to owners) and state aid.[5]

Measures which violate national treatment encompass special operational restrictions on foreign-owned firms. These include requirements that a minimum share of production (sometimes 100 per cent) be exported and local content provisions requiring foreign firms to source a certain share of inputs domestically.[6] Foreign investors meeting such performance requirements usually receive financial inducements, such as tax concessions and duty-free importation of components.

National treatment requires a high degree of transparency in all legislative and administrative procedures affecting foreign-owned entities. Ideally, they should be published and regularly updated. Administrative procedures, which are likely in practice to be a greater obstacle to foreign than domestic investment, should be streamlined.

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4 Even following ‘in principle’ approval, further delays are often experienced in implementing the project due to the need to obtain additional authorisations and permits, frequently from sub-national (state, provincial and regional) authorities.

5 Legislative provisions guaranteeing ‘fair and equitable’ treatment for foreign investors do not necessarily ensure national treatment.

6 Operational restrictions can also cover personnel requirements, such as immigration and other controls on overseas recruitment of key staff.

Investment incentives

Investment incentives are often non-discriminatory, applying equally to all investors, although some discriminate in favour of foreign investment. They usually take the form of tax and credit concessions, grants and the provision of subsidised infrastructure facilities. As they are frequently negotiated on a case-by-case basis, they can vary substantially across projects.

A number of inquiry participants commented on the widespread availability of investment incentives overseas. Some firms, such as Union Carbide, Bosch and Burns Philp, stated that the availability of investment incentives can influence investment decisions, especially in more risky projects. However, the majority of participants saw such incentives as essentially providing the 'icing on the cake' and having a negligible impact on their investment decisions (see Chapter 3). This evidence tends to be supported by results from various investment surveys.

10.3 APEC measures affecting ADIA

All economies, including OECD member countries, operate a mixture of policies that both restrict and encourage foreign investment across all sectors. Assessing the overall impact of these regimes on foreign investment, as well as the extent of sectoral variations, is difficult.

No APEC economy fully extends national treatment and the right of establishment to foreign investors. The foreign investment regimes of APEC economies have been summarised by PECC (1995a) (see Figure 10.1).[7] Fiscal incentives, which do not always violate national treatment, are used extensively by APEC economies to attract foreign investment. Moreover, as indicated in Figure 10.2, sensitive industries or sectors are often closed or significantly restricted to overseas investment.

Given the diversity among APEC economies, it is useful to classify them into three broad groups: developed; developing Asian; and developing non-Asian APEC economies.

[7] This figure records only the existence of impediments to foreign investment, and does not measure the restrictiveness of these elements in each country. Thus, the figure should not be used to make comparisons of the relative openness of foreign investment regimes across APEC economies.

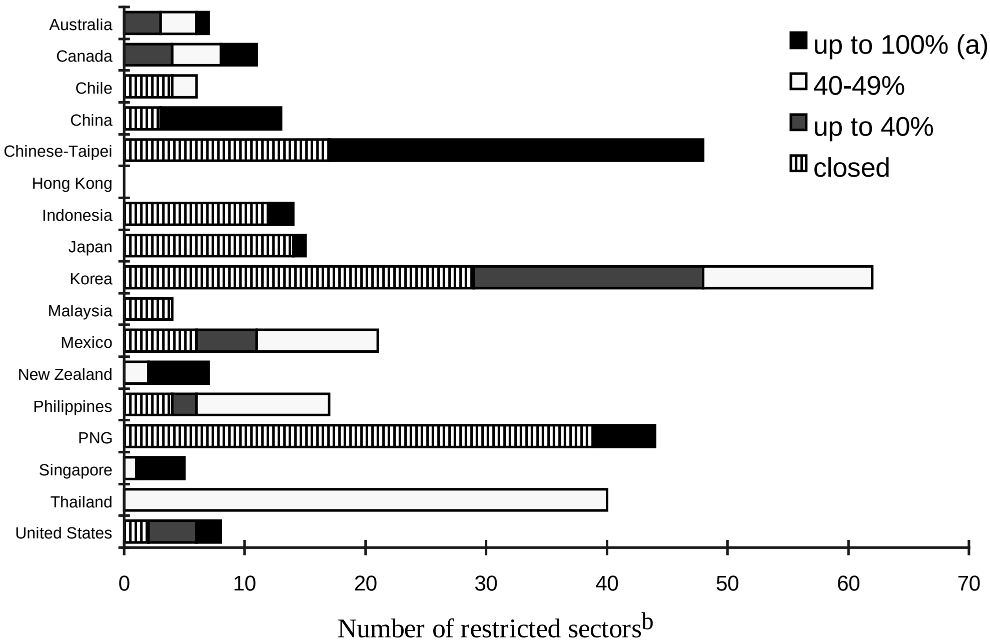
Figure 10.1: Schematic representation of major foreign direct investment impediments across APEC

	AUS	BD	CDA	CHL	PRC	HK	INA	JPN	ROK	MAS	MEX	NZ	RP	PNG	SIN	CT	THA	US
Screening/ notification	þ	þ	þ	þ	þ	□	þ	þ	þ	þ	þ	þ	þ	þ	□	þ	þ	□
Restricted/ closed sectors	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ	þ
Performance requirements	□	□	□	þ	þ	□	þ	□	þ	þ	□	□	þ	þ	□	þ	þ	□
Fiscal incentives	□	□	□	□	þ	□	þ	þ	þ	þ	þ	□	□	þ	þ	þ	þ	□
Taxation	□	□	□	þ	þ	□	þ	þ	þ	þ	□	□	þ	þ	þ	þ	þ	□
Priority sectors	þ	þ	□	□	þ	□	þ	□	□	þ	þ	□	þ	þ	□	þ	þ	□
Exchange controls	□	þ	□	□	þ	□	□	□	þ	□	□	□	□	þ	□	þ	□	□

Note: Shaded areas represent impediments to foreign direct investment. In order, the country abbreviations refer to Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Philippines, Papua New Guinea, Singapore, Chinese Taipei, Thailand and the United States.

Source: PECC 1995a.

Figure 10.2: Sectors subject to foreign investment restrictions, by APEC economy



a Foreign ownership levels vary in this category subject to the investment fulfilling certain operational requirements or conditions. These include: export requirements; local content provisions; geographical limitations; and conditions such as reciprocity.

b Sectors correspond to the 4-digit International Standard Industrial Classification (ISIC 1990).

Sources: APEC 1994, 1996; Jardine and Jackson 1996; UN Statistical Office 1990 and PECC 1995a.

Developed APEC economies

Foreign investment measures maintained by this group of economies, which comprises Australia, Canada, Japan, New Zealand and the United States, are summarised in Table 10.1.

All developed APEC countries require some form of authorisation for, and notification by, foreign investors. For example, in Japan, inward foreign investment is only required to be notified after implementation, except in certain industries and from specific countries where pre-notification is needed. New Zealand reviews all investment proposals exceeding set levels, and investments must generally be notified.

In these countries, most sectors are open to foreign investment. However, entry restrictions and controls generally apply to certain sensitive sectors, especially financial services, real estate, fishing, media and telecommunications.

Developed APEC economies generally do not impose operational restrictions on foreign-owned entities. Investment incentives apply in all of these countries except New Zealand, but do not discriminate in favour of foreign investors other than in Japan.

Developing Asian APEC economies

This group includes Brunei, China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Chinese Taipei and Thailand. Their investment regimes, most of which have undergone substantial liberalisation in recent years, are summarised in Table 10.2.

Investment arrangements vary widely within this group, but are generally more complex and restrictive than those of developed APEC members. Restrictions on entry and right of establishment are widespread. Except for Hong Kong, these countries prohibit foreign investment in some sectors, especially in media and real estate.

Moreover, all developing countries except Hong Kong restrict foreign ownership to varying degrees. While Singapore restricts ownership in a few sectors, such as banking and broadcasting, others limit foreign equity in a wider range of industries. The level of foreign ownership permitted is often conditional on entering joint ventures with domestic parties or meeting certain operational requirements, such as performance arrangements.

Table 10.1: Key features of foreign investment regimes, by developed APEC economy

	Equity structure[a]	*Priority sectors*	*Notification and licensing*	*Operational restrictions*	*Tax incentives or exemptions*
Australia	Some foreign ownership limits (eg 15% in commercial television broadcasting).	Some priority sectors (eg information technology and telecommunications).	Notification to the Foreign Investment Review Board required for investments over A$5m. Investments over A$50m require full examination.	None.	Provided according to national treatment.
Canada	Up to 100% foreign ownership allowed in all sectors except certain restricted areas.	None.	Acquisitions exceeding Can$5m reviewed. Notification applies to other investments.	Generally no restrictions except for federally incorporated corporations.	Provided according to national treatment.
United States	Restrictions in areas of national security (eg nuclear energy and transport).	None.	Some screening and notification requirements apply.	No operational restrictions. Foreign exchange controls for some countries.	Provided according to national treatment.
Japan	No foreign ownership limits except in some restricted sectors.	None.	Prior notification needed for investment in some sectors.	None.	Generally provided according to national treatment.
New Zealand	100% ownership in some restricted sectors such as air transportation and telecommunications.	None.	Approval needed to acquire a 25% or more share in a NZ company, acquire assets exceeding NZ$10m or invest in fishing, broadcasting or rural property.	None.	Provided according to national treatment.

a See Figure 10.2.
Sources: BIE 1995i, PECC 1995a and APEC 1996.

Operational restrictions in the form of performance requirements (for example, local content provisions, minimum export levels and technology transfer arrangements) prevail in these countries.

Investment incentives are offered by all developing Asian APEC economies, sometimes discriminating in favour of foreign investment. Incentives are often tied to meeting certain performance requirements.

Developing non-Asian APEC economies

The investment regimes of Chile, Mexico and Papua New Guinea are summarised in Table 10.3. These countries require all foreign investment to be authorised. In some areas, foreign investment is limited. For instance, Mexico prohibits or restricts foreign investment in a large number of sectors, including petroleum extraction and refining, automobile parts and fishing. Foreign investment in fishing, real estate and media is restricted in Chile. Papua New Guinea permits foreign investment only if it is judged to be beneficial to the nation (for example, by contributing to economic growth, generating employment, expanding exports, developing regional areas or using domestic resources). Investment incentives, sometimes available only to foreign investors, apply in all of these countries.

10.4 Current liberalisation initiatives

Despite recent liberalisation, APEC economies continue to employ many measures which violate right of establishment and national treatment. In addition, increasing use is being made of potentially distorting investment incentives.

An essential starting point for a host country liberalising its investment regime should be the review and removal of measures not conforming to the key principles of right of establishment and national treatment, unless good reasons existed not to do so (see Figure 10.3). Meeting these key market-conforming principles would ensure the removal of those measures which discriminate most against foreign investment. Any exceptions could be clearly identified, and their use restricted to meeting legitimate concerns, such as national security. Ideally, they should be transparent and continuously reviewed. Additional efforts should aim at controlling the increasing global use of investment incentives.

Table 10.2: Key features of foreign investment regimes, by developing Asian APEC economy

	Equity structure[a]	*Priority sectors*	*Notification and licensing*	*Operational restrictions*	*Tax incentives or exemptions*
Brunei	Up to 100% foreign ownership permitted, except in resource-based sectors subject to national food security.	Export-oriented, high technology and capital intensive industries.	Prior registration is required. Certain investments 'screened'.	None.	National treatment. Pioneer industries exempt from corporate tax and import duties on raw materials and capital goods.
China	Up to 100% foreign ownership permitted if foreign firm contributes to exports, or transfers technology.	Agricultural development, infrastructure, civilian aeroplanes, technology and export-oriented industries.	Complex national and local approval arrangements. Different approval requirements cover restricted and prohibited sectors.	Some restrictions (eg technological transfer requirements and import-reducing requirements). Foreign exchange controls.	Different taxation treatment for domestic and foreign enterprises. Tax deductions available to foreign enterprises in special economic zones, and particular industries.
Chinese Taipei	Up to 100% ownership permitted for 'negative list' of exempt sectors.	High technology and high value-added products (eg communications, aerospace and special chemicals).	Approval required for all foreign investment.	Local content requirements for automotive industry. Approval required for investments over US$5m by individuals or over US$10m by companies.	National treatment. Tax incentives in certain activities. Reduced tax on repatriated profits. Duty exemptions for projects in Export Processing Zones.
Hong Kong	No ownership limits.	None.	Only for banking, insurance and securities dealing.	None.	National treatment.
Indonesia	Up to 100% foreign ownership permitted (with divestment requirements after 15 years). Negative list of exempt sectors.	Export-orientated industries.	Foreign investment approved by decree. Licences required.	Export requirements of 65% in certain sectors. Local content provisions apply.	National treatment. Limited concessions for foreign firms in some industries. Foreign firms granted concessional import duties on capital goods.

Table 10.2 (continued):

	Equity structure[a]	*Priority sectors*	*Notification and licensing*	*Operational restrictions*	*Tax incentives or exemptions*
Korea	No limits, with exceptions (negative list). Joint ventures required for certain manufacturing activities.	Advanced technology industries.	Prior notification usually required. 49 industries need approval.	No explicit requirements. Most foreign exchange transactions are licensed.	Tax incentives and import duty exemptions apply to some foreign investment (eg high technology).
Malaysia	Policy goal of 30% foreign ownership overall. Up to 100% foreign ownership permitted in particular industries, subject to export and other conditions.	Manufacturing (export-oriented industries), technology and tourism.	Must be licenced and registered with Registrar of Companies.	Export and technological transfer requirements. Local content requirements in motor vehicles.	Tax incentives available for manufacturing investment. Tax exemptions exist for foreign firms conducting R&D. Free trade zones operate.
Philippines	Foreign investment limits range from 30% to 100%. Ownership in certain sectors depends on export requirements, local content, the size of investment, and technology used.	Export-oriented and advanced technology industries.	Registration requirements apply.	Export, local content, technological transfer and foreign exchange requirements in certain sectors.	National treatment, but some preferential tax treatment to foreign enterprises. Investments must be in preferred sectors in less-developed regions.
Singapore	100% foreign ownership allowed in all sectors (excluding publicly-owned sectors), except banks (maximum 40%).	None.	Must be registered with the Ministry of Finance.	None. No formal exchange controls.	National treatment, with various incentives available for R&D, capital investment and exporting.
Thailand	Up to 100% foreign ownership except in restricted sectors (maximum 49%). Foreign divestment required in restricted sectors.	Manufacturing and export-oriented industries.	Licence required (by Ministry of Commerce) for entities containing more than 49% foreign equity.	Export requirements and local content provisions for certain manufactured goods. Generally no foreign exchange controls.	National treatment. Tax incentives for investments in remote areas; import duty exemptions on raw materials and machinery.

a See Figure 10.2.
Sources: BIE 1995i, PECC 1995a and APEC 1996.

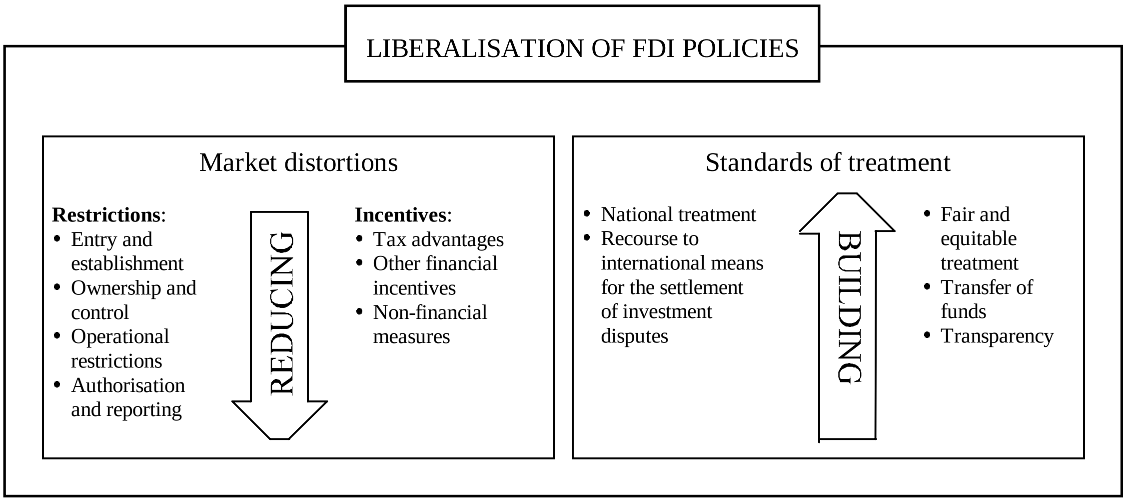
Table 10.3: Key features of foreign investment regimes, by developing non-Asian APEC economy

	Equity structure[a]	*Priority sectors*	*Notification and licensing*	*Operational restrictions*	*Tax incentives or exemptions*
Chile	No foreign ownership limits outside restricted sectors.	None.	The Central Bank must approve all proposals.	Local content requirements in motor vehicles. Companies with payroll exceeding 25 people must employ at least 85% nationals. Capital repatriation allowed after one year. Additional tax may apply to repatriated profits.	National treatment. Tax exemptions for some foreign investment in remote areas.
Mexico	Foreign ownership limits range from 10% (eg production cooperatives) to 100% (eg food, textiles, leather, hotels and restaurants).	Export-orientated industries, small and medium-size businesses.	Approval required for foreign investments in restricted areas. Elsewhere, approval is automatic upon registration, subject to certain conditions.	Export requirements; local content provisions for investments in the motor vehicle industry.	No tax incentives available. Free trade zones operate with import duty exemptions.
Papua New Guinea	Up to 100% foreign ownership permitted in all sectors. Entry restrictions apply, unless project satisfies criteria of contributing to economic growth; creating new jobs; using domestic resources; assisting in skill acquisition; expanding exports; or developing remote areas.	Manufacturing.	Foreign investment requires prior approval from the Bank of Papua New Guinea, and certification by the Investment Promotion Authority.	Export requirements and local content programs apply. Exchange controls are generally limited; fund transfers normally approved when required.	Various taxation-based incentives available for both domestic and foreign investment projects.

a See Figure 10.2.

Sources: BIE 1995i, PECC 1995a and APEC 1996.

Figure 10.3: Main elements of a favourable investment climate



Source: Adapted from UNCTAD 1994.

Unilateral achievements

It is important to note that the substantial liberalisation made to date in many APEC economies has occurred unilaterally, outside of any international framework (PECC 1995b). As in the case of trade reform, this has reflected an understanding that liberalisation is in the countries' own best interests, irrespective of the practices of other governments.

Australia also has liberalised its foreign investment regime extensively over the past decade. Some restrictions still remain. Their removal would generally benefit Australia, and would also help in its efforts to reduce barriers overseas. For example, one area that may need review is the operations and requirements of the Foreign Investment Review Board, which has been criticised by foreign governments as restricting some investment into Australia.

International investment agreements

Governments, including that of Australia, have participated also in international efforts to reform investment regimes — bilaterally, regionally and multilaterally. Under certain conditions (discussed later), international investment agreements may complement domestically-based reforms and contribute to global liberalisation. However, to be successful, international agreements generally need to be underpinned by strong domestic commitments from participating governments. And these in turn require understanding of the costs of maintaining impediments to foreign investment.

Several arguments can be advanced in favour of the need for multilateral investment rules:

- First, international rules and obligations can 'lock in' unilateral reforms by members, making reversals more difficult. This reduces uncertainty and adds to the confidence and willingness of investors to invest.
- Second, investment liberalisation is not a 'zero-sum game' — the gains are increased if all economies liberalise. This can help governments gain domestic support for reforms. More specifically, they can claim that the structural costs domestically of their own reforms will be more than compensated for by the increased market access gained by their investors to overseas markets.[8]
- Third, such a system with uniform rules can facilitate 'mutual disarmament', limiting the extent to which governments destructively compete with each other by offering generous incentives for foreign investment.

Regional agreements

A number of existing regional agreements affect Australia, either directly as a result of membership, or by involving countries that are important investment markets or sources of investment for Australia. Some agreements are applied on an unconditional MFN (most-favoured-nation) or open (non-discriminatory) basis, with concessions extended to members also available to non-members. Others, such as the North American Free Trade Agreement (NAFTA), apply conditional MFN treatment by allowing member countries (Mexico, the United States and Canada) to discriminate against non-members. These preferential arrangements can distort investment flows by diverting them away from countries outside the agreement, including Australia. (Appendix G provides a more detailed account of the various approaches to investment liberalisation.)

APEC non-binding investment principles

Under the Bogor Declaration, APEC members endorsed the objective of 'free and open trade and investment' by 2010 for developed countries, and 2020 for developing economies. At the November 1995 Osaka meeting, APEC leaders confirmed this objective — reiterating their commitment to unconditional MFN treatment — and adopted an Action Agenda as a blueprint for its achievement.

An important starting point for APEC's investment initiatives was the approval of a set of 'Non-binding APEC Investment Principles' in November 1994.

8 However, failure to reach acceptable international agreement on investment liberalisation may be seen by governments as a reason to delay unilateral reforms.

These cover: transparency; non-discrimination between source economies; national treatment; use of investment incentives and performance requirements; repatriation and convertibility; settlement of disputes; entry and sojourn of personnel; and avoidance of double taxation. However, the APEC voluntary investment principles, which were weakened from the initial proposals, fall well short of providing an adequate investment agreement.[9] Many of the principles could be strengthened, especially in relation to the use of investment incentives and performance requirements, transfer of funds, capital movements, national treatment and right of establishment. For example, on the use of investment incentives, the APEC Investment Principles only require member economies "not to relax health, safety, and environment regulations as an incentive to encourage foreign investment". Similarly, members are required only to "minimise the use of performance requirements that distort or limit expansion of trade and investment".

Moreover, the APEC principles contain no 'standstill' and 'rollback' provisions to reduce progressively exceptions to national treatment and rights of establishment.[10] And no commitment exists in the Principles to limit and reduce the use of exceptions to national treatment, although there is a commitment in the APEC Action Agenda to progressive liberalisation.

In the Osaka Action Agenda to implement the Bogor Declaration, leaders agreed to prepare Individual Action Plans on investment that would provide progressively for MFN, national treatment and transparency, using as an initial framework the WTO, the APEC Principles, and any commonly agreed guidelines on investment developed within APEC. They agreed to explore the expansion of APEC's network of bilateral investment agreements.

APEC members have also agreed to implement collective actions on investment designed to facilitate investment, mainly through greater dialogue with the business community and increased transparency.

Bilateral investment agreements

The number of bilateral agreements involving APEC economies has grown rapidly in recent years. All but one APEC member (Brunei) have bilateral investment agreements or agreements containing provisions on investment. The United States had signed 24 such treaties (including NAFTA) by 1993.

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[9] See, for example, APEC 1995.

[10] 'Standstill' provisions would require that no further exceptions to right of establishment and national treatment be introduced. 'Rollback' commitments would require that existing exemptions be wound back. Although the APEC Principles do not specifically mention right of establishment, it is included under national treatment.

Australia maintains a number of bilateral investment agreements. These generally provide for MFN treatment and contain provisions aimed at investment promotion. They also extend certain transparency requirements and protect foreign investors from expropriation and certain other requirements.

The Closer Economic Relations Agreement (CER) with New Zealand does not cover foreign investment directly. However, its provisions on trade in services overlap with a number of foreign investment issues — investment being an important means by which services are traded internationally. Although services trade is subject to the foreign investment policies of the two countries (Article 2), CER imposes some standstill and rollback conditions on performance requirements and certain investment incentives. No member can introduce a measure, as a condition for providing a service, that is discriminatory or a disguised restriction on trade.

Multilateral investment agreements

Australia has also been actively involved in a number of multilateral initiatives aimed at promoting a stable and predictable climate conducive to international investment (see Appendix G).

OECD investment instruments

Australia, together with other OECD members (several also being APEC economies), is a signatory to the OECD's investment instruments — which are the closest thing currently to a multilateral investment agreement. These instruments include the two Codes of Liberalisation of Capital Movements and Current Invisible Operations, adopted in 1961 when the OECD was formed, and the national treatment provisions contained in the 1976 Declaration and Decisions on International Investment and Multilateral Enterprises.

These instruments — apart from the national treatment declaration — are 'legally binding' within the OECD framework. Taken together, they provide for: national treatment of investors, both pre- and post-establishment; repatriation of profits, dividends, rents and the proceeds of liquidated investments; transparency of regulations; a consultative mechanism for dealing with complaints; and a peer review process for promoting rollback of remaining restrictions. Governments may impose restrictions only for reasons of national security, public order, health and morality, but these are subject to ongoing multilateral scrutiny.

OECD multilateral agreement on investment

In May 1995, OECD Ministers agreed that the existing OECD investment instruments were inadequate and needed to be replaced by an OECD multilateral agreement on investment (MAI). It was thought that there was a need for stronger, more uniform, multilateral investment rules to help overcome weaknesses in the existing OECD investment instruments. It is intended that the MAI be open to non-OECD members.

Weaknesses of the current OECD instruments include the non-binding nature of the national treatment declaration and the failure of attempts to introduce effective standstill and rollback commitments, with instead substantially lesser requirements of applying equal treatment progressively for foreign investors being adopted. Also, although OECD members are encouraged to extend in a non-discriminatory manner the application of the Codes to all non-OECD countries that are members of the International Monetary Fund, the proliferation of special reciprocity arrangements between members, especially in banking and finance, has detracted from national treatment.

OECD countries are currently negotiating the MAI, with a view to finalising it by May 1997. Their objective is to achieve "an agreement with high standards for the liberalisation of investment regimes and investment protection with effective dispute settlement procedures".

GATT/WTO initiatives

Although the GATT/WTO would appear to have advantages in administering a multilateral investment agreement, attempts to have investment incorporated into the GATT/WTO have met with little success. For example, efforts to include investment directly in the Uruguay Round were rejected; instead a heavily watered-down agreement was included that covered only specified Trade-Related Investment Measures (TRIMS) and excluded export performance requirements and investment incentives.

Foreign direct investment is the major means by which services are traded internationally. The formation of the General Agreement on Trade in Services (GATS) following the Uruguay Round has effectively brought foreign investment in services within the WTO by including commercial presence as one of the modes of supplying services. However, foreign direct investment in goods remains outside the scope of the WTO.

World Bank guidelines

Since 1992, the World Bank has provided a voluntary set of advisory guidelines on the Treatment of Foreign Direct Investment. They are based on equal treatment of investors in similar circumstances and free competition, and cover rights of establishment, expropriation and dispute settlement. They also recognise that performance requirements are often counter-productive, and recommend against using tax exemptions or other fiscal incentives to attract foreign investment. However, few countries fully implement these suggested guidelines.

10.5 Desirable features of an international investment agreement

Governments continue to espouse the need for a more coordinated global approach to investment liberalisation. Ideally, the same framework for liberalising foreign investment regimes should be applied to all reforms, whether adopted in unilateral, regional or multilateral contexts. Regional and other international investment agreements are more likely to complement unilateral reforms when they include universally agreed rules and disciplines that reinforce the key principles of right of establishment and national treatment. Transparency is important in achieving these principles. However, international agreements should include several additional criteria if they are to safeguard the global liberalisation process. These criteria are discussed below.

Non-discrimination and openness

Regional investment agreements should not discriminate between members and non-members, and should be open to outsiders to join on the same terms as existing members. Unconditional MFN treatment between investment sources is important to ensure that regional agreements do not become inward-looking preferential arrangements that provide more favourable access to members than to non-members. Maintaining open membership provides important protection against this occurring.

Open membership may also assist in controlling reciprocity deals between members that make the provision of national treatment and right of establishment in certain sectors conditional on receiving similar treatment from abroad. APEC is intended to meet this objective, through the so-called concept of open regionalism.

Controlling investment incentives and performance requirements

Governments are using investment incentives increasingly as a means of competing against each other to attract foreign investment. Where these investment incentives do not discriminate between domestic and overseas sources, or provide more favourable treatment to foreign investors, they do not violate national treatment or right of establishment. The possibility of effectively controlling the recent proliferation of competitive incentive schemes is seen as one of the main advantages offered by international investment agreements.

It is generally recognised that:

> To a degree, competition for FDI is not undesirable ... Yet, unbridled competition among governments can lead to abuses ... Competing for FDI can lead to waste, especially when governments offer more and higher incentives than those justified to cover the wedge between the social and private rates of return on an investment, and when distortions in the international allocation of investment are introduced (UNCTAD 1995, p. 300).

Moreover, governments individually may come to recognise that their countries' long-term economic interests may not be best served by short-term advantages gained through incentives. International forums can help expedite this understanding.

Investment incentives and performance requirements are incompatible with the objective of achieving a more market-oriented investment regime. Investment agreements should contain specific standstill and rollback undertakings on their use (see Table 10.4). Agreements would ideally ban or limit such arrangements, or at least the most distorting types.

Binding agreements

An investment agreement that is binding on members may be more effective than a voluntary arrangement, especially when backed up with an effective dispute-settlement mechanism. Binding commitments may reduce the risk of future policy backsliding.

However, the practical significance of making legally-binding international commitments is difficult to assess. Compliance depends ultimately on the strength of commitment and peer group pressure. Governments frequently break binding commitments by recourse to some technicality or escape clause negotiated in the agreement. Moreover, even where sanctions or enforcement penalties exist, these are often difficult to apply and may be costly for all parties to implement.

Table 10.4: Menu of policy options for government action on incentives

Level of approach	*Voluntary*[a]	*Non-binding*[a]	*Binding*
Unilateral	National FDI incentives reviews, including the balance between incentives and promotion measures.		
Bilateral		Incorporate language on ceilings and limits into model bilateral treaties on investment and double taxation.	Eliminate or reduce certain incentives, conditional on same action by certain other countries.
Regional		Regional FDI incentive reviews.	Agree on ceilings and discontinuation of certain incentives; approval system; review system.
Multilateral		Eminent Persons Group; negative list; check list of points; 'challenge' round pledging reductions.	Strengthen and expand WTO instruments.

a While voluntary initiatives are unilateral actions that can be reversed easily, a non-binding understanding, being the result of negotiations, can impose some degree of restraint.

Source: UNCTAD 1995.

The importance attached to obtaining mandatory commitments may therefore be misplaced. Non-binding or voluntary agreements can still be effective. Indeed, they may contain more substantive commitments than binding agreements, which are frequently watered down in the negotiations. The key remains domestic understanding of the benefits of maintaining a liberal investment regime.

Effective dispute-settlement mechanism

International investment agreements, whether mandatory or not, require an effective dispute-settlement mechanism. The mechanism must be capable of resolving disputes efficiently and objectively, using transparent rules and procedures which have the full support of members. An appeal mechanism requiring third party integration would usually be desirable.

10.6 Implications for Australia's approach

Substantial liberalisation of foreign investment has occurred globally and within the APEC region during the past decade. Governments have undertaken reforms unilaterally for the most part, with the aim of improving the performance of their economies. However, it is apparent that substantial barriers to foreign investment remain.

Many governments continue to discriminate against foreign investors by imposing investment restrictions that violate the key principles of right of establishment and national treatment. At the same time, governments are increasingly using investment incentives in an attempt to compete internationally for foreign investment.

It is in Australia's economic interests to encourage other governments to open their economies further to foreign investment. This, of course, is no easy matter and, as noted previously, will require an understanding by the countries concerned that liberalisation best serves their own economic interests.

A precondition for such understanding is adequate information about the existence and (domestic) effects of impediments to inward direct investment. The recent PECC study, sponsored by APEC, on which this chapter has drawn, is an important step in achieving some transparency in this area. But more needs to be done.

The Commission recommends that the Australian Government promote further studies to document and analyse the economic effects of barriers to trade and investment in main markets, including within the APEC region.

Australia's credibility in encouraging other countries to engage in reform will be enhanced by its own record in liberalising foreign trade and investment. Australian action can serve also as a 'demonstration effect' of the benefits of reform. While Australia has undertaken some major reforms in the past 10 to 15 years, significant barriers to both trade and foreign investment remain.

Benefits may also arise from Australia pursuing international initiatives as a means of achieving investment liberalisation. In particular, Australia should continue to press for international liberalisation through the WTO and the OECD. These bodies appear to offer the best prospects for achieving effective multilateral investment reforms.

The OECD has traditionally handled international investment matters. With Australia's support, member countries are well advanced in negotiating an MAI to replace the existing (inadequate) investment instruments. This provides an important opportunity for Australia to push for foreign investment liberalisation.

While an MAI within the OECD has the potential to achieve a substantial and binding agreement, it would exclude many important developing Asian economies, such as China, which are important not only on account of their proximity to Australia, but also because they now account for a major, and increasing, share of world investment.

Apart from the WTO's broader membership, the eventual inclusion of an investment agreement in that organisation would offer other advantages. Trade and investment are clearly linked. Discussion of investment barriers in the WTO would therefore provide scope for significant synergies by enabling investment to be integrated into the existing multilateral trading system. A number of trade agreements — such as those on trade-related investment measures and, more importantly, services — already cover investment. The more robust dispute settlement procedures now available in the WTO also could be used to resolve future investment disputes. Against these advantages must be set the greater difficulty of obtaining broad agreement to substantial reforms across the diverse membership of the WTO.

Australia should continue its efforts to bring about a Multilateral Agreement on Investment within the OECD. It should also seek to have an investment agreement negotiated within the WTO. Given the likely difficulties in achieving the latter agreement, it may need to begin as an agreement among a sub-group of WTO members.

Regional initiatives, such as APEC, may also facilitate investment liberalisation in markets significant to Australia. The current Non-Binding Investment Principles, while an important initial achievement, are weak in a number of areas. Strengthening these Principles would contribute to the APEC Action Agenda objective of achieving free and open investment in the Asia Pacific region. Australia should resist the inclusion of provisions in regional arrangements that are discriminatory (conditional MFN) and inconsistent with broader multilateral objectives.

APPENDICES

APPENDIX A: PUBLIC CONSULTATION

The Commission received the terms of reference for this inquiry in late August 1995. The inquiry was advertised widely, and an *Issues Paper* was sent to a large number of individuals and organisations. During the inquiry, the Commission held informal discussions with a wide range of organisations (see Section A.1) and held three round-table meetings (Section A.2). In addition, 52 written submission were received, including submissions by the major industry organisations (Section A.3). The Commission is grateful to all those who participated in the inquiry.

A.1 Visits with individuals and organisations

The Commission did not hold initial public hearings, but early in the inquiry commenced an extensive round of visits. The Commission was fortunate in being able to meet with the chief executives of many of the companies and organisations it visited. Discussions were held with the following:

Australian Capital Territory

Aboriginal and Torres Strait Islander Commission
Altman, Professor J, Centre for Aboriginal Economic Policy Research
Austrade
Australia-Japan Research Centre
Australian Taxation Office
Bora, Dr B, Flinders University
Bureau of Industry Economics
Commonwealth Environment Protection Agency
The Commonwealth Treasury
Department of Foreign Affairs and Trade
Department of Prime Minister and Cabinet
Dodson, Mr P, Council of Aboriginal Reconciliation
Farley, Mr R
Metal Trades Industry Association
Minerals Council of Australia
Visy Paper Pty Ltd

New South Wales

Aboriginal and Torres Strait Islander Social Justice Commissioner
AMP Investments
ANZ Banking Group Ltd
Arthur Andersen
Austrade
Brambles Industries Ltd
BHP Ltd
Burns Philp and Co. Ltd
Century Capital Corporation
Coca-Cola Amatil Ltd
James Hardie Industries Ltd
McKinsey and Co. Ltd
Pioneer International Ltd
QBE Insurance Ltd
Reserve Bank of Australia
Tubemakers of Australia Ltd
Union Carbide Chemicals (Australia) Pty Ltd
Wattyl Ltd
Westpac Banking Corporation

Victoria

Amcor Ltd
ANZ Banking Group Ltd
Arthur Andersen
Australian Chamber of Manufactures
Australian Coalition of Service Industries
Australian Manufacturing Council
Broken Hill Proprietary Company Ltd
Business Council of Australia
CRA Ltd
Freebairn, Professor J, Melbourne University
Garmond Australia Pty Ltd
Kraft Foods Ltd
Lloyd, Professor P, Melbourne University
National Australia Bank Ltd
Newcrest Mining Ltd
Pacific Asia Industries Pty Ltd
Pacific Dunlop Australia Ltd
Robert Bosch (Australia) Pty Ltd

Western Mining Corporation Holdings Ltd

South Australia

Aboriginal and Legal Rights Movement
Bundy Asia Pacific
Crown Solicitor's Office
Kimberley Land Council
Department of Minerals and Energy
Department of the Premier and Cabinet

Queensland

MIM Holdings Ltd

Western Australia

Aboriginal Legal Service of Western Australia
Association of Mining and Exploration Companies
Chamber of Mines and Energy of Western Australia
Department of Minerals and Energy
Ministry of the Premier and Cabinet
Moonstone Diamond Corporation
National Native Title Tribunal

New Zealand

Air New Zealand
Ajax Fasteners
Brierley Investments Ltd
Ceramco Corporation Ltd
Comalco New Zealand Ltd
Fisher and Paykel Industries Ltd
Fletcher Challenge Ltd
Foreign Direct Investment Advisory Group
Heinz-Wattie Ltd
Lion Nathan Ltd
New Zealand Business Roundtable
New Zealand Commerce Commission
New Zealand Employers' Federation
Overseas Investment Commission
The Treasury

A.2 Round-tables

In October 1995 and February 1996, the Commission held three round-table meetings. Those on 25 and 26 October were kindly organised by the Australian Chamber of Commerce and Industry. They were attended by a range of company representatives who discussed a variety of issues with the Commission. The third was organised by the Commission to discuss in detail certain international taxation matters that had been raised during visits. Participants in each round-table are listed below.

Sydney, 25 October 1995

Australian Chamber of Commerce and Industry
Chadwick Holdings Pty Ltd
Goodman Fielder Ltd
New South Wales Chamber of Commerce and Industry
Rosedale Advisory Services

Brisbane, 26 October 1995

Australian Chamber of Commerce and Industry
Burleigh Textiles
Cheetah Swimwear
D R Manufacturing Pty Ltd
Gateway Customs Brokers
Goodtime Products
Hallmark Mitex Pty Ltd
Hamilton Watts International
QII Enterprise Initiative
Queensland Chamber of Commerce and Industry
The Australian Coat Company Pty Ltd
TPJ International Trade and Business Services
William A Cook Australia Pty Ltd

Canberra, 27 February 1996 — International taxation issues

Mr Colin Allum	The Commonwealth Treasury
Mr Philip Anderson	Arthur Andersen
Mr Harvey Anderssen	Bureau of Industry Economics
Mr Matthew Benge	Australian National University
Professor John Freebairn	Melbourne University
Mr William Glass	Pioneer International Ltd
Dr Johannes Jüttner	Macquarie University

Mr Howard Pender	Australian National University
Mr Patrick Sedgley	The Treasury
Mr Richard Vann	University of Sydney
Mr Peter Wilson	New Zealand Treasury

A.3 Public hearings and submissions

In July 1996, the Commission held a public hearing in Canberra to discuss the draft report. In lieu of a normal public hearing, a video conference was held with the Association of Mining and Exploration Companies in Western Australia.

Throughout the inquiry, the Commission received a total of 54 submissions. The submissions are listed below. Those that were presented at the public hearings are indicated by an asterisk (*).

Participant	*Submission number*
Aboriginal and Torres Strait Islander Commission	51
Aboriginal and Torres Strait Islander Social Justice Commissioner	26, 50
ACT Fireworks	5
Arthur Andersen	54
Association of Mining and Exploration Companies*	19, 30
Austrade	25
Australian Bureau of Statistics	39
Australian Business Chamber	41
Australian Chamber of Manufactures	7
Australian Electrical and Electronic Manufacturers' Association	16
Australian Stock Exchange Ltd	6
Australian Taxation Office*	29
BHP Ltd	15, 38
Brambles Industries Ltd	34
Bryan, Dr D and Rafferty, Mr M	36
Burns Philp and Co. Ltd	10
Business Council of Australia	22, 35
Chamber of Mines and Energy of Western Australia	14
Commonwealth Environment Protection Agency	40
The Commonwealth Treasury	48
Coopers and Lybrand	37
Council of Textile and Fashion Industries of Australia Ltd*	23, 32, 46
CRA Ltd	13

Department of Minerals and Energy of Western Australia	21, 43
Department of Foreign Affairs and Trade	47
Freehill Hollingdale and Page	8
Garmond Australia Pty Ltd	3
Gwalia Consolidated Ltd	11
KPMG	52
National Native Title Tribunal	27
Nelson, Mr Peter J	2
Northern Land Council*	28, 31, 44
Northern Territory Minerals Council	53
Mark One Apparel Pty Ltd	17
Metal Trades Industry Association	9, 18
Minerals Council of Australia*	24, 42
Pacific BBA Ltd	1
Pioneer International Ltd	4
Richardson, A J D and Bolan, J B	20
Robert Bosch (Australia) Ltd	12
South Australian Government	45
St George Bank Ltd	49
Telstra Corporation Ltd	33

APPENDIX B: TRENDS IN ADIA AND OTHER INVESTMENT

This appendix contains statistical tables showing how ADIA has changed over time and how it has varied relative to other components of Australian investment abroad and in relation to domestic aggregates such as private domestic investment, foreign direct investment in Australia and GDP. The tables are:

- Table B.1: Stock of Australian investment abroad, 1981 to 1995;
- Table B.2: ADIA relative to GDP, FDI inflows, domestic investment and capital stock, 1960–61 to 1994–95;
- Table B.3: Nominal and real income from overseas investment, 1980–81 to 1994–95;
- Table B.4: OECD direct investment annual outflows, as a percentage of GDP, 1981 to 1994;
- Table B.5: ADIA stock, by industry, 1981 to 1989;
- Table B.6: ADIA stock, by industry, 1990 to 1995;
- Table B.7: Distribution of ADIA stock, by country, 1980 to 1995;
- Table B.8: Country composition of ADIA stock, 1980 to 1995; and
- Table B.9: Sectoral/industrial composition of ADIA stock, by country, at 30 June 1995.

Table B.1: Stock of Australian investment abroad, 1981 to 1995 ($ million)[a]

	Official[b]	*Non-official*[c]			*Total AIA*
At 30 June		*ADIA*	*Portfolio and other*	*Total*	
1981	6 795	4 562	2 718	7 280	14 075
1982	7 781	5 845	2 894	8 739	16 520
1983	12 223	6 510	3 785	10 295	22 518
1984	14 377	7 631	4 698	12 329	26 706
1985	15 872	9 771	8 117	17 888	33 760
1986	15 567	13 018	14 699	27 716	43 283
1987	20 535	20 597	21 639	42 236	62 771
1988	23 258	30 915	20 447	51 362	74 619
1989	23 446	37 273	28 698	65 970	89 417
1990	24 933	39 488	31 799	71 287	96 221
1991	27 570	38 365	33 866	72 231	99 801
1992	25 028	43 554	40 707	84 261	109 289
1993	23 579	45 653	52 300	97 953	121 532
1994	23 970	47 784	61 306	109 090	133 060
1995	22 949	52 492	65 785	118 277	141 226

a In nominal terms, at market values.

b Overseas investments undertaken by Commonwealth, State and local governments and the Reserve Bank of Australia. Official investment abroad includes reserve assets, lending and an ‘other’ component.

c Includes government business enterprises.

Source: ABS, Cat. No. 5363.0.

Table B.2: ADIA relative to GDP, FDI inflows, domestic investment and capital stock, 1960–61 to 1994–95

	ADIA outflows ($m)	*FDI inflows ($m)*	*ADIA outflow/ GDP (%)*	*ADIA outflow/ domestic investment (%)*	*ADIA stock ($m)*	*ADIA stock/ domestic capital stock (%)*
1960–61	19	375	0.1	1.1	na	na
1961–62	21	221	0.1	1.2	na	na
1962–63	14	384	0.1	0.7	na	na
1963–64	13	425	0.1	0.6	na	na
1964–65	32	540	0.2	1.3	na	na
1965–66	39	512	0.2	1.4	na	na
1966–67	38	364	0.2	1.3	na	na
1967–68	47	561	0.2	1.6	na	na
1968–69	60	600	0.2	1.7	na	na
1969–70	129	736	0.4	3.5	na	na
1970–71	71	897	0.2	1.7	na	na
1971–72	120	870	0.3	2.7	na	na
1972–73	98	399	0.2	2.1	na	na
1973–74	243	616	0.5	4.6	na	na
1974–75	94	657	0.1	1.5	na	na
1975–76	167	578	0.2	2.3	na	na
1976–77	255	1 062	0.3	3.1	na	na
1977–78	215	1 040	0.2	2.3	na	na
1978–79	225	1 357	0.2	1.9	na	na
1979–80	391	1 538	0.3	3.1	4 219	2.3
1980–81	511	2 441	0.4	3.2	4 562	2.2
1981–82	670	2 451	0.4	3.4	5 845	2.4
1982–83	582	1 070	0.3	3.1	6 510	2.4
1983–84	1 263	2 003	0.6	6.5	7 631	2.6
1984–85	1 743	2 615	0.8	7.6	9 771	3.0
1985–86	2 759	3 606	1.1	10.1	13 018	3.4
1986–87	4 616	4 743	1.7	14.7	20 597	4.8
1987–88	10 146	8 113	3.4	27.0	30 915	6.7
1988–89	6 624	12 188	2.0	15.5	37 273	7.4
1989–90	2 355	7 489	0.6	5.3	39 488	7.2
1990–91	-937	7 269	0.0	0.0	38 365	6.7
1991–92	1393	5 734	0.4	4.0	43 554	7.4
1992–93	2 844	5 496	0.7	7.6	45 653	7.4
1993–94	6 323	6 012	1.5	15.7	47 784	7.5
1994–95	4 709	8 158	1.0	10.1	52 492	8.0

na not available. ADIA stock data prior to 1979–80 were not classified on a market value basis.

Sources: ABS, Cat. Nos. 5363.0, 5221.0 and 5204.0.

Table B.3: Nominal and real income from overseas investment, 1980–81 to 1994–95 ($ million)

	Income in current prices					*Real income*[a]		
	ADIA income			*Portfolio and other*	*Non-official*	*ADIA income*	*Portfolio and other*	*Non-official*
	Reinvested earnings	*Distributed*	*Total*					
1980–81	200	205	405	115	520	865	246	1 111
1981–82	106	215	321	95	416	622	184	806
1982–83	205	197	402	128	530	705	224	929
1983–84	309	252	561	143	704	920	235	1 155
1984–85	315	159	474	196	670	736	304	1 040
1985–86	681	337	1 018	312	1 330	1 482	454	1 936
1986–87	1 176	407	1 583	511	2 094	2 150	694	2 844
1987–88	2 163	131	2 294	588	2 882	2 897	742	3 638
1988–89	2 165	0	2 166	689	2 854	2 515	800	3 314
1989–90	1 360	219	1 579	1 018	2 597	1 731	1 116	2 846
1990–91	204	222	426	1 118	1 544	453	1 188	1 641
1991–92	555	314	869	1 163	2 032	907	1 213	2 121
1992–93	2 045	334	2 379	1 238	3 617	2 453	1 276	3 729
1993–94	2 434	272	2 706	1 326	4 032	2 759	1 352	4 111
1994–95	3 866	300	4 166	1 373	5 539	4 166	1 373	5 539

a In 1994–95 dollar values. Derived using the GDP deflator.

Sources: ABS, Cat. Nos. 5363.0; 5305.0 and 5204.0.

Table B.4: OECD direct investment annual outflows, as percentage of GDP, 1981 to 1994

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*
Australia	0.4	0.4	0.3	0.8	1.2	2.0	2.6	2.0	1.2	0.3	0.7	-0.1	0.3	2.0
Austria	0.3	0.2	0.3	0.1	0.1	0.3	0.3	0.2	0.7	1.0	0.8	1.0	0.8	0.6
Belgium-Luxembourg[a]	0.0	-0.1	0.4	0.4	0.3	1.4	1.8	2.3	3.8	3.3	2.9	4.7	1.9	3.2
Canada[a]	2.0	0.2	0.8	0.7	0.8	1.1	1.7	1.1	0.8	0.7	0.9	0.7	1.3	1.0
Denmark	0.2	0.1	0.3	0.2	0.5	0.8	0.6	0.7	1.9	1.2	1.4	1.6	1.0	2.7
Finland	0.3	0.2	0.3	1.0	0.7	1.2	1.3	2.5	2.7	2.4	0.9	0.4	2.2	3.9
France[a]	0.8	0.6	0.4	0.4	0.4	0.7	1.0	1.3	1.9	2.3	1.7	1.4	1.0	0.8
Germany	0.6	0.4	0.5	0.7	0.8	1.1	0.8	1.0	1.2	1.5	1.4	1.4	0.6	0.7
Iceland[a]	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.1	0.1	0.2	0.4	0.0	na
Italy[a]	0.3	0.3	0.5	0.5	0.4	0.4	0.3	0.7	0.2	0.7	0.6	0.5	0.7	0.4
Japan[a]	0.4	0.4	0.3	0.5	0.5	0.7	0.8	1.2	1.5	1.6	0.9	0.5	0.3	0.4
Netherlands	2.5	1.9	1.5	2.0	2.2	1.8	3.3	1.8	5.0	4.7	4.1	4.0	3.3	3.5
New Zealand	0.4	0.4	1.7	0.1	0.8	0.3	1.5	1.4	0.3	5.4	3.5	0.9	-2.8	4.3
Norway	0.3	0.6	0.7	1.1	2.1	2.3	1.1	1.1	1.5	1.4	1.7	0.4	0.9	1.5
Portugal	0.1	0.0	0.1	0.0	0.1	0.0	0.0	0.2	0.2	0.3	0.7	0.9	0.2	0.2
Spain[a]	0.1	0.3	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.6	0.7	0.2	0.5	0.9
Sweden	0.7	1.2	1.6	1.6	1.8	3.0	3.0	4.1	5.3	6.3	2.9	0.5	0.7	3.3
Switzerland	0.0	0.0	0.5	1.3	4.9	1.1	0.7	4.7	4.4	2.8	2.8	2.0	2.8	2.5
Turkey	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1
United Kingdom	2.4	1.5	1.8	1.9	2.4	3.0	4.5	4.4	4.2	1.9	1.5	1.6	2.7	2.9
United States	0.3	0.0	0.2	0.3	0.3	0.4	0.6	0.4	0.7	0.5	0.6	0.6	0.9	0.9

a Reinvested earnings are not included in official statistics.

Source: OECD 1995a.

Table B.5: ADIA stock, by industry[a], 1981 to 1989 ($ million, at 30 June each year)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Mining									
Coal, oil and gas	16	47	10	42	53	66	120	218	123
Other mining	293	884	653	959	726	863	1 564	2 477	2 593
Services to mining (incl. exploration)	138	195	525	704	546	2 188	2 603	3 106	3 574
Total	448	1 127	1 188	1 705	1 325	3 117	4 287	5 801	6 290
Manufacturing									
Food, beverages and tobacco	38	32	50	39	42	77	426	2 113	1 209
Textiles, clothing and footwear[b]	3	11	18	19	13	44	272	100	np
Wood products and furniture	11	10	6	3	1	-1	np	np	np
Paper products and publishing	42	152	153	565	1 095	1 050	1 607	3 517	5 154
Chemicals, petroleum and coal products	90	606	194	216	232	128	229	329	398
Non-metalic mineral products	740	304	253	363	253	397	546	-157	1 348
Basic metal products	714	333	381	347	1 786	996	1 042	1 175	1 182
Fabricated metal products	226	387	485	253	173	43	139	129	np
Transport equipment	49	61	24	51	22	3	17	20	np
Other machinery and equipment	85	95	115	136	170	181	510	532	590
Miscellaneous manufacturing	20	14	534	38	49	93	169	147	np
Total	2 018	2 005	2 213	2 030	3 836	3 011	4 953	7 905	10 207

Table B.5 (continued):

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Other industries									
Construction	37	48	130	177	160	260	632	np	674
Wholesale and retail trade	381	374	400	683	674	633	788	1 062	2 372
Transport and storage	233	360	421	464	576	724	880	806	1 170
Finance, property and business services	1 262	1 605	1 932	2 487	3 259	4 769	7 670	13 842	15 323
Electricity, gas and water	8	14	14	26	14	0	0	0	0
Other industries	20	128	88	100	117	49	868 [b]	np	318
Agriculture, forestry, fishing and hunting	29	35	37	50	74	44	5 [b]	60	np
Unallocated	126	149	89	-92	-265	410	514	200	np
Total	2 095	2 713	3 110	3 896	4 609	6 889	11 358	17 209	20 776
Total all industries	4 562	5 845	6 510	7 631	9 771	13 018	20 597	30 915	37 273

np not published.

a Industries receiving (rather than undertaking) ADIA. The industry category is based on ASIC. The data relate to the industries to which ADIA is initially directed, and not necessarily where the funds are finally used.

b IC estimates based on ABS data.

Sources: ABS, Cat. Nos. 5363.0 and 5305.0.

Table B.6: ADIA stock, by industry[a], 1990 to 1995 ($ million, at 30 June each year)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*
Mining						
Coal, oil and gas	189	-61	-59	53	87	112
Other mining	1 856	2 624	1 854	2 562	2 728	3 180
Services to mining (incl. exploration)	3 353	3 179	4 604	4 528	4 124	4 189
Total	5 399	5 742	6 399	7 144	6 938	7 481
Manufacturing						
Food, beverages and tobacco	np	np	1 575	1 340	1 576	1 766
Textiles, clothing, footwear and leather	np	np	578	699	635	np
Wood and paper product	453	543	613	559	781	np
Printing, publishing and recorded media	4 859	4 162	5 332	6 104	7 863	10 033
Petroleum, coal, chemical and associated product	1 761	2 562	2 669	3 451	2 330	2 665
Non-metallic mineral product	938	1 099	1 393	1 492	1 169	1 200
Metal product	1 431	1 414	1 596	1 445	1 425	1 237
Machinery and equipment	963	768	1 126	1 321	1 134	1 190
Other	47	52	64	39	42	85
Total	12 495	12 534	14 946	16 450	16 955	19 786

Table B.6 (continued):

	1990	*1991*	*1992*	*1993*	*1994*	*1995*
Other industries						
Construction	593	882	970	1 019	944	758
Wholesale trade	1 095	1 245	1 347	1 952	1 910	1 642
Retail trade	234	851	620	738	289	1 018
Transport and storage	1 436	1 327	821	885	705	865
Finance and insurance	15 412	14 019	16 077	15 176	18 503	19 287
Property and business services	1 580	1 479	1 642	1 020	618	842
Government administration and defence	0	0	0	0	0	0
Electricity, gas and water	0	0	0	np	np	np
Other industries	304	-209	402	607	393	369
Agriculture, forestry, fishing and hunting	np	np	np	np	np	np
Unallocated	np	np	np	82	np	np
Total[b]	21 594	20 089	22 209	22 059	23 890	25 225
Total all industries	39 488	38 365	43 554	45 653	47 783	52 492

np not published.

a Industries receiving (rather than undertaking) ADIA. The industry category is based on ANZSIC. The data relate to the industries to which ADIA is initially directed, and not necessarily where the funds are finally used.

b IC estimates based on ABS data.

Sources: ABS, Cat. No. 5363.0.

Table B.7: Distribution of ADIA stock, by country,[a] 1980 to 1995 ($ million)

At 30 June	*United States*	*United Kingdom*	*New Zealand*	*ASEAN*	*Papua New Guinea*	*Other*	*Total*	*APEC*[b]
1980	553	499	340	1193	244	1 390	4 219	3 137
1981	655	469	441	1774	438	785	4 562	3 515
1982	763	735	544	2023	742	1 038	5 845	4 320
1983	905	755	666	1562	533	2 089	6 510	4 355
1984	1 348	1 249	800	1136	560	2 538	7 631	4 317
1985	2 427	1 958	791	676	504	3 415	9 771	5 546
1986	4 042	2 438	1 522	309	720	3 987	13 018	8 181
1987	5 043	3 287	2 982	884	1 307	7 094	20 597	12 239
1988	5 524	9 440	4 470	845	1 663	8 973	30 915	15 184
1989	9 789	10 001	4 425	2 116	1 345	9 597	37 273	19 700
1990	8 139	12 847	5 788	2 964	1 405	8 345	39 488	17 751
1991	7 516	14 108	6 208	2 894	1 507	6 132	38 365	17 711
1992	9 901	15 272	6 006	3 265	1 686	7 424	43 554	22 335
1993	11 065	14 112	7 354	3 665	2 061	7 396	45 653	25 156
1994	10 105	18 803	7 336	2 809	2 162	6 569	47 784	24 655
1995	13 073	20 481	8 374	2 946	1 972	5 646	52 492	27 675

a Countries to which ADIA is initially directed and not necessarily where the funds are finally used.

b Data before 1989–90 are IC estimates. Excludes China, Republic of Korea, Chinese Taipei, Chile and Mexico.

Sources: ABS, Cat. Nos. 5305.0 and 5352.0.

Table B.8: Country composition of ADIA stock, 1980 to 1995 (per cent)

At 30 June	*United States*	*United Kingdom*	*New Zealand*	*ASEAN*	*Papua New Guinea*	*Other*	*Total*	*APEC*
1980	13.1	11.8	8.1	28.3	5.8	32.9	100.0	74.4
1981	14.4	10.3	9.7	38.9	9.6	17.2	100.0	77.0
1982	13.1	12.6	9.3	34.6	12.7	17.8	100.0	73.9
1983	13.9	11.6	10.2	24.0	8.2	32.1	100.0	66.9
1984	17.7	16.4	10.5	14.9	7.3	33.3	100.0	56.6
1985	24.8	20.0	8.1	6.9	5.2	35.0	100.0	56.8
1986	31.0	18.7	11.7	2.4	5.5	30.6	100.0	62.8
1987	24.5	16.0	14.5	4.3	6.3	34.4	100.0	59.4
1988	17.9	30.5	14.5	2.7	5.4	29.0	100.0	49.1
1989	26.3	26.8	11.9	5.7	3.6	25.7	100.0	52.9
1990	20.6	32.5	14.7	7.5	3.6	21.1	100.0	45.0
1991	19.6	36.8	16.2	7.5	3.9	16.0	100.0	46.2
1992	22.7	35.1	13.8	7.5	3.9	17.0	100.0	51.3
1993	24.2	30.9	16.1	8.0	4.5	16.2	100.0	55.1
1994	21.1	39.3	15.4	5.9	4.5	13.7	100.0	51.6
1995	24.9	39.0	16.0	5.6	3.8	10.8	100.0	52.7

Sources: ABS, Cat. Nos. 5305.0 and 5352.0.

Table B.9: Sectoral/industrial composition of ADIA stock, by country, at 30 June 1995

	$m	*% of country total*	*% of industry total*	*% of ADIA stock*
United Kingdom				
Manufacturing	8 074	39.4	40.8	15.4
Other industries[a]	12 407	60.6	37.9	23.6
Finance, insurance, property and business services	11 498	56.1	57.1	21.9
Total	**20 481**	**100.0**		**39.0**
United States				
Mining	5 406	41.4	72.3	10.3
Manufacturing	6 375	48.8	32.2	12.1
Services[b]	1 292	9.9	5.1	2.5
Total	**13 073**	**100.0**		**24.9**
New Zealand				
Mining	141	1.7	1.9	0.3
Manufacturing	2 075	24.8	10.5	4.0
Petroleum, coal, chemicals and associated products	769	9.2	28.9	1.5
Services[b]	6 158	73.5	24.4	11.7
Finance, insurance, property and business services	4 547	54.3	22.6	8.7
Total	**8 374**	**100.0**		**16.0**
ASEAN				
Mining	126	4.3	1.7	0.2
Manufacturing	1 590	54.0	8.0	3.0
Petroleum, coal, chemicals and associated products	1 386	47.0	52.0	2.6
Services[b]	1 230	41.8	4.9	2.3
Finance, insurance, property and business services	916	31.1	4.6	1.7
Total	**2 946**	**100.0**		**5.6**
Papua New Guinea				
Mining	1 326	67.2	17.7	2.5
Manufacturing	209	10.6	1.1	0.4
Services[b]	437	22.2	1.7	0.8
Total	**1 972**	**100.0**		**3.8**

Table B.9 (continued):

	$m	*% of country total*	*% of industry total*	*% of ADIA stock*
Netherlands				
Finance, insurance, property and business services[c]	625	64.0	3.1	1.2
Total	**977**			**1.9**
Canada				
Manufacturing	217	34.3	1.1	0.4
Total	**633**			**1.2**
Hong Kong				
Finance, insurance, property and business services	456	87.9	2.3	0.9
Total	**519**			**1.0**

a All other industries except manufacturing. Data for mining and several service industries were not published.

b The total for all industries (including agriculture, electricity, gas and water, and unallocated industries) except manufacturing and mining sectors. As data for several service industries were not published, the total for the service sector cannot be found directly. However, within these countries, ADIA in agriculture, electricity, gas and water, and unallocated industries was zero or close to zero.

c Finance and insurance only.

Sources: ABS, Cat. Nos. 5363.0 and 5352.0.

APPENDIX C: SURVEYS ON MOTIVES FOR OFFSHORE INVESTMENT

One means of identifying the factors underlying offshore investment decisions is to survey firms that have established, or have considered establishing, offshore operations. This appendix summarises the key findings of some surveys of Australian firms. It is not a comprehensive summary, but rather seeks to provide a sampling of relevant surveys. These range from very small in scope to some much more substantial surveys.

C.1 Industry Commission (1996)

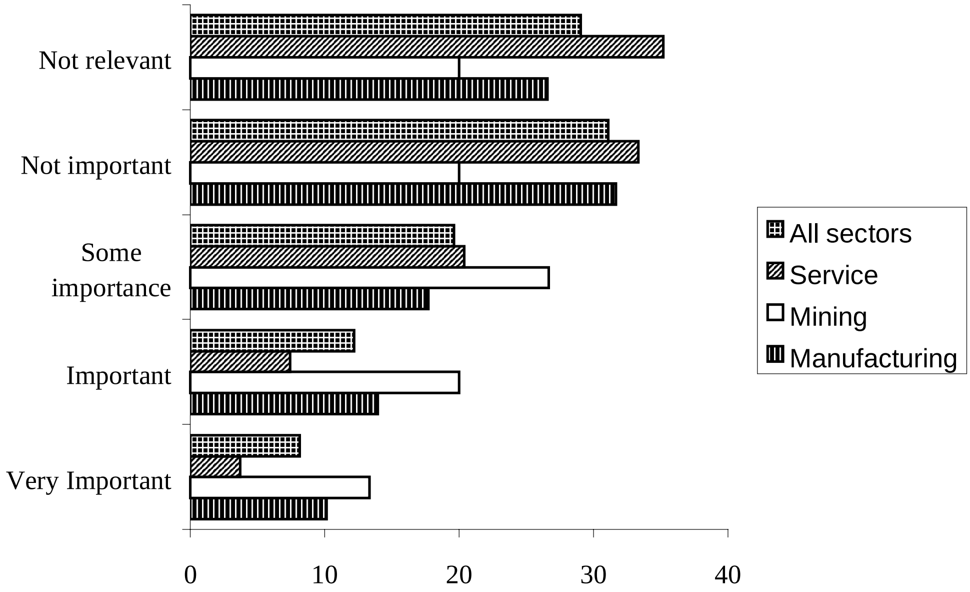
In December 1995, as part of this inquiry, the Commission conducted a survey of firms with offshore operations. A questionnaire was sent to some 400 firms in Australia, and 299 responded. This represented a response rate of over 74 per cent. Of those who responded, 148 had direct investments overseas — 79 in manufacturing, 54 in service sector activities, and 15 in mining activities (see Appendix D for full details).

While the survey was directed mainly at the impact of offshore investments on the Australian economy, it also sought views on motivations underlying companies' offshore investment activities — in particular, the importance of government-related factors (such as taxation arrangements and competition policy) relative to commercial considerations (for example, cost advantages and growth opportunities in the host country).

The survey revealed that, while for most firms Australian government influences have not been important or relevant in their decisions to invest abroad (60 per cent of the total respondents), they are, nevertheless, of considerable influence for some firms and sectors. For instance, 20 per cent of the respondents in all sectors (including one-third of the mining firms) saw them as either important or very important (see Figure C.1).

The survey also found that, while commercial considerations dominated motives for offshore investment, competition policy, labour market regulation, taxation arrangements and Australian tariff policy were each cited by about 14 per cent of respondents as influencing the decision to invest offshore.

Figure C.1: Importance of Australian government influences relative to commercial considerations (percentage of responses)



Source: IC survey (see Appendix D).

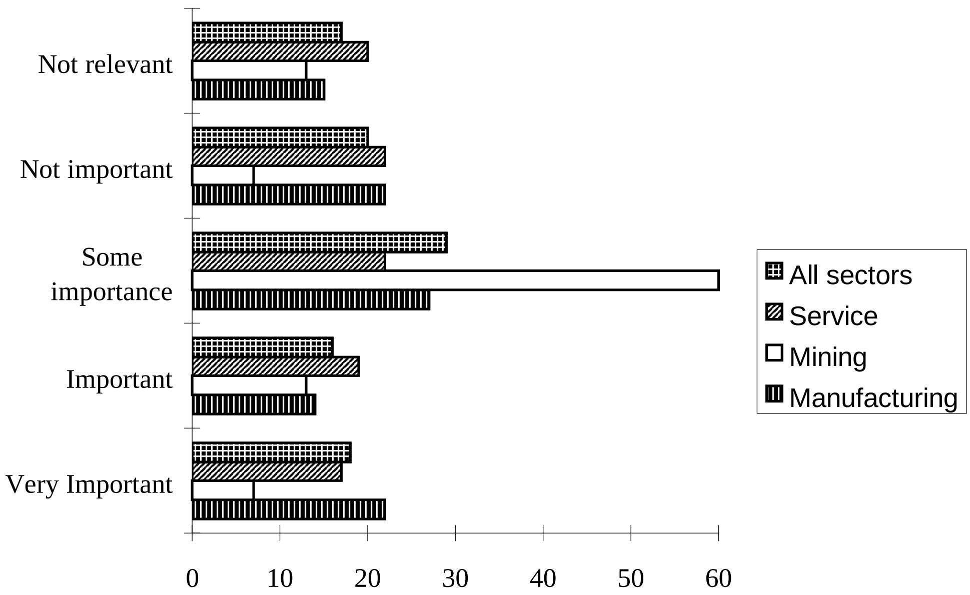
Survey participants attached greater importance to influences subject to control by overseas governments. For instance, 34 per cent of all respondents saw overseas government factors to be either important or very important in their decisions to invest offshore (see Figure C.2). Overseas tax incentives and tariff barriers were identified by 26 and 22 per cent of the firms, respectively, as influencing their decision to invest offshore.

The major survey findings about the economic effects of ADIA are reported in Chapter 4. The responses to all questions are tabulated in Appendix D.

C.2 Industry Commission (1995)

Also as part of this inquiry, the Commission undertook a more limited survey by adding some questions to the Business Council of Australia (BCA) half yearly Survey of Business Conditions. It covered 25 BCA member firms which had made decisions to invest offshore during the past three years.

Figure C.2: Importance of foreign government influences relative to commercial considerations (percentage of responses)



Source: IC survey (see Appendix D).

The Commission's questions focused on the importance of government factors relative to commercial factors as influences on firms' decisions.[1] About 44 per cent of respondents said that Australian government factors were of minor importance relative to commercial factors, while 36 per cent saw them as either important or very important. The balance (20 per cent) found them not to be relevant.

In contrast, respondents again attributed greater value to overseas government factors — 52 per cent found them to be either important or very important, while 40 per cent saw them as of minor importance. Only 8 per cent considered them to be of no relevance.

[1] Government factors were defined as including taxation, labour market regulation, other regulatory arrangements, trade barriers and financial incentives. Commercial factors comprised growth opportunities, the need to locate closer to customers, the availability of natural resources etc.

C.3 Bureau of Industry Economics (1995)

To address information gaps relating to ADIA, the BIE (1995f) surveyed 35 manufacturing and 10 service sector firms engaged in offshore investment during 1994 and 1995. Data provided by the manufacturing firms suggest that they account for the majority of Australian manufacturing investment abroad. In contrast, (as the BIE acknowledged) the coverage of the services sector was very thin.

The objective of the survey was to understand the reasons for the firms' competitive advantages, and to obtain information on such matters as: their Australian and overseas operations (including skills and capabilities lost and gained); their investments for the seven years to June 1994; and their expectations about investments, sales, exports, employment, R&D and the rate of return for their Australian and overseas operations for the period June 1994 to June 1999.

The survey requested respondents to allocate 100 notional 'points' among the factors which were most influential in their decisions to invest offshore. The factors were grouped into five categories:

Category	*Motive of investing firm*
Cost-based	to obtain the lowest possible unit cost on their output, usually by seeking the most productive and lowest cost inputs
Market-based	to access as many markets or consumers as possible
Natural resource-based	to seek natural resources, such as minerals and energy
Australian government policies	to avoid government-induced difficulties in operating in Australia
Host government policies	to take advantage of policies favourable to operating in the selected host country

Manufacturing

The survey found that market-based factors were key considerations in the decisions of firms to invest offshore, accounting for 71 per cent (on an unweighted basis) of the overall motivation for the manufacturing sample (see Table C.1). This was followed by cost-based considerations (14 per cent). Natural resource factors and government policies in both countries were relatively unimportant. When the averages are weighted by each company's share of the sample's total world-wide assets, the percentage for market-based factors rises to 77 per cent, but that for cost-based factors drops to almost half. This suggests that smaller companies placed more importance on cost-based factors than larger companies.

Within each broad group, firms were also asked to indicate the three most important specific motivations for investment abroad and to allocate 100 points among them (see Table C.2).

Table C.1: Broad motivations for manufacturing direct investment abroad, 1 July 1987 to 30 June 1994

Broad motivation category	*(1)* *Unweighted (per cent)*	*(2)* *Weighted (per cent)*
Market-based	71.3	77.0
Cost-based	14.1	7.7
Host government policies	8.6	4.1
Australian government policies	4.0	5.3
Natural resource-based	1.9	5.9

Note: Results in Column 2 are averages weighted by each company's share of the manufacturing sample's total world-wide assets. Totals may not add to 100 due to rounding.

Source: BIE 1995f, p. 73.

Table C.2 shows that the "growth potential of the selected country" accounted for 61 per cent of the market-based factors, and was the most important single reason for this category of motivation. In regard to Australian government factors, competition policy was the most dominant specific reason for investing offshore. This accounted for 71 per cent of the Australian government factors. Within host government policy factors, political stability was nominated as the most important motivational factor.

Services

The most prominent motivation for service-oriented firms surveyed was market-based factors (83 per cent). This motivation was relatively more important for service sector firms than for manufacturing firms. Cost-based and host government policy-related motivations accounted for 11 per cent and 6 per cent, respectively (see Table C.3). By comparison, manufacturing firms attached slightly greater importance to these factors (14 per cent and 9 per cent of broad motivation, respectively — see Table C.1). Australian government policies and natural resource-based factors were unimportant to service firms.

Table C.2: Most important specific reasons for manufacturing investment abroad, 1 July 1987 to 30 June 1994

Broad motivation category and specific reason	*Relative importance to the broad motivation category* *(per cent)*
Market-based	
Growth potential of the selected country	61.1
Closer proximity to customers	16.6
Distribution	10.3
Cost-based	
Lower input costs and more reliable supplies	38.4
Lower labour costs	23.7
Lower export costs	15.8
Natural resource-based	
Agricultural inputs	61.5
Scarce materials	38.5
Host government policies	
Political stability	60.6
Quality of economic institutions	15.6
Protection offered, to by-pass tariffs	12.8
Australian government policies	
Competition policy	71.4
Other regulations	19.1
Tariffs	9.5

Note: Each score represents the relative importance of the specific reason within the relevant broad motivation category.

Source: BIE 1995f, p. 75.

When the results are weighted by each firm's share of the sample's world-wide assets, the percentage of the cost-based factors drops from 11 per cent to around 3 per cent, suggesting again that the smaller firms placed greater weight on cost-based factors than larger firms. For service firms, host government factors jumped from 6 per cent to about 16 per cent, suggesting that larger firms placed greater importance on these factors than the smaller firms. This is in contrast to results obtained for manufacturing where smaller firms placed greater importance on host government factors. Because the sample size is small, these findings may not be a meaningful generalisation.

For the service firms surveyed, greater growth potential accounted for 73 per cent of the market-based motivations — 12 percentage points higher than the corresponding figure for manufacturing firms (see Tables C.4 and C.2). Within host government policies, good macroeconomic management (54.5 per cent of the total motivations) and political stability (45.5 per cent) were important reasons "for selecting a particular country".

Table C.3: Broad motivations for service sector direct investment abroad, 1 July 1987 to 30 June 1994

Broad motivation category	*(1)* *Unweighted (per cent)*	*(2)* *Weighted (per cent)*
Market-based	83.1	81.5
Cost-based	10.6	2.8
Host government policies	6.3	15.7
Australian government policies	0.0	0.0
Natural resource-based	0.0	0.0

Note: Results in Column 2 are averages weighted by each company's share of the service sample's total world-wide assets.

Source: BIE 1995f, p. 76.

Table C.4: Most important specific reasons for service investment abroad, 1 July 1987 to 30 June 1994

Broad motivation category and specific reason	*Relative importance to the broad motivation category (per cent)*
Market-based	
Greater growth potential - home market limited	52.5
Greater growth potential - home market not limited	20.7
Distribution	9.9
Host government policies	
Macroeconomic management	54.5
Political stability	45.5

Source: BIE 1995f, p. 77.

C.4 Edwards and Buckley (1995)

This is a joint study by Ron Edwards of Monash University and Peter Buckley of Bradford University in the United Kingdom. Between 1992 and 1994, Edwards and Buckley surveyed the overseas operations of 38 Australian manufacturing firms in the United Kingdom (20 firms), Malaysia (14) and Thailand (4). The results are reported in Edwards (1994) and Edwards and Buckley (1995).

The survey concluded that the main motivation for establishing subsidiaries offshore was to gain access to markets — market growth was the primary motive for 90 per cent of respondents with operations in Malaysia, 95 per cent of those in the United Kingdom and 75 per cent of those in Thailand.

Sixty per cent of the firms with subsidiaries in Malaysia reported that competitive labour costs were a secondary motive. A similar percentage was attracted to Malaysia by the low cost of business overheads (such as power and communications). Three of the four respondents in Thailand also cited low labour costs as an important secondary motive.

None of the Australian firms in the United Kingdom mentioned cost factors as a motive. However, some said that labour costs there are low by European standards and that this influenced their choice of region in the United Kingdom. Other secondary motives included protection from tariffs, access to raw materials and access to processing capacity for Australian production.

C.5 Metal Trades Industry Association (1995)

In the course of preparing its submission to the Commission, the MTIA conducted detailed interviews with the chief executive officers of 30 member companies. The MTIA judged that the companies were a representative sample of its membership with offshore operations.

Consistent with the BIE and Commission surveys, the main finding was that offshore location decisions are primarily market-driven. For most firms, the main reason for establishing offshore operations was to locate in a large and growing market. This was identified as important by 81 per cent of the companies with a manufacturing operation offshore, while 75 per cent indicated that proximity to overseas customers was important to them. Inducements offered by host governments were seen as a secondary, but nevertheless important, influence. Trade barriers imposed by foreign governments were considered to be an important reason for establishing offshore operations by 56 per cent of those survey respondents already offshore.

The MTIA said that, while cost-based motivations are secondary factors, they are, nonetheless, important in firms' decisions to locate offshore. For instance, cheaper labour and/or materials were a significant influence for 31 per cent of those surveyed companies which had established, or were establishing, manufacturing operations offshore. Lower establishment costs and tax incentives were significant influences for 24 per cent of the respondents.

C.6 Australian Electrical and Electronic Manufacturers' Association (1995)

In preparing its submission to this inquiry, AEEMA undertook a survey of six member companies which have established manufacturing operations in China, Hong Kong, Indonesia, New Zealand, Malaysia, Sri Lanka and the United Kingdom. The six companies cited the following reasons for locating offshore.

- For successful market penetration, it was considered important to be located near customers.
- High levels of protection in some APEC economies encouraged overseas production.
- Lower costs of labour, transportation and raw materials were important reasons for investing in other countries.
- Some countries offer powerful financial incentives. For example, AEEMA members which have located in Malaysia cited the country's Pioneer Status program as an important reason for locating operations there.
- Proximity to high technology clusters and leading edge customers was important for firms engaged in the development of elaborately transformed manufactures.
- Sales opportunities can arise from the religious characteristics of the host country. For example, a reason for one firm choosing Indonesia was the opportunities it presented for sales in the Middle East.

C.7 Maitland (1995)

This survey formed part of a study on 'Australian Investment in Vietnam' by Elizabeth Maitland of the University of Melbourne. Information on 35 Australian companies operating investment projects in Vietnam was obtained from the Australian-Vietnamese Business Council and Vietnam Investment Review. Nineteen companies with investments in Vietnam responded to the survey.

According to the survey, establishing a long-term presence, the strong growth prospects of the economy and the size of the Vietnamese market were key considerations which influenced Australian firms to invest in Vietnam. Low wage costs and access to raw materials were said to be motivations of lesser importance.

C.8 East Asia Analytical Unit (1992 and 1994)

The East Asia Analytical Unit (EAAU) of the Department of Foreign Affairs and Trade has conducted two surveys to investigate reasons underlying ADIA in South-East Asia.

In mid-1992, the EAAU conducted a survey of Australian businesses dealing in and with Asia. Responses were received from 126 businesses, 45 per cent of which had invested in South-East Asia. The EAAU (1992) concluded that:

> While lower production costs than in Australia may have been a factor in their decision to set up [operations] offshore, trade barriers in the host economy, proximity to customers, access to raw materials and taking advantage of intra-ASEAN preferential trade arrangements may also have been considerations. In view of the fact that only one-fifth of the investors intended to export back to Australia, lower costs offshore may have been a minor consideration (p. 120).

A second survey covering 18 Australian firms which had invested in South-East Asia was undertaken in late 1993. It revealed that the main motives for investing in that region were, first, to have a share in expected growth by obtaining 'insider' positions and, second, to reduce the costs of Australian operations by, for example, minimising transport costs and avoiding costly trade barriers.

C.9 Allen Consulting Group (1994 and 1995)

As part of its study of the trade and investment links between Australia and Britain (undertaken for the Committee for Melbourne), the Allen Consulting Group (1994) reported on the main reasons which underpinned the decisions of Australian firms to invest in Britain. They include: growth opportunities in that market; access to natural resources; knowledge of the market and the business culture, in some cases arising from a long business relationship (for example, the four major banks have had branches in London for many years); confidence that they can add value to the businesses acquired; similar legal and accounting systems, and in many industries similar regulatory systems; opportunities for expansion into other European markets; and the English language.

Similarly, in another study which examined links between Australia and Germany, the Allen Consulting Group (1995b) reported on the main reasons which underpinned the decisions of Amcor to invest in Germany. Amcor is one of Australia's largest producers of packaging and one of the world's leading producers of corrugated boxes. The key reasons for its investment were: to obtain a significant share in the German market; to build critical mass in Europe; and to use the base in Germany to support expansion in Eastern Europe.

C.10 McKinsey & Co. (1993)

In 1993, McKinsey & Co. prepared a report, entitled *Emerging Exporters* (McKinsey 1993), for the Australian Manufacturing Council on Australia's high value-added manufacturing exporters. Included in the report were the results of a survey of 39 manufacturing firms with offshore operations (about 13 per cent of the firms surveyed). The firms were asked, among other things, to list the top three reasons for starting offshore production. The survey showed that the main motivations to go offshore were:

- proximity to customers (59 per cent of total responses);
- growth of markets (46 per cent);
- lower labour cost (44 per cent);
- lower freight and cartage costs (28 per cent); and
- government assistance (23 per cent).

C.11 State Bank of New South Wales and Chamber of Manufactures of New South Wales (1993)

This was a joint quarterly Survey of Manufacturing Conditions and Future Prospects in New South Wales. It covered 506 manufacturing firms in that State. The survey concluded that labour costs were the most significant factor in a firm's decision to move offshore. Other important influences were: tariff changes; more advantageous tax systems; and infrastructure costs. The survey also revealed that large firms were more likely to have moved offshore than smaller firms, and that the industry sector with the greatest propensity to relocate offshore was clothing and footwear.

C.12 Bennett, Merchan and Metcalfe (1981)

The survey results are based on data collected in a survey conducted by a consultancy firm on behalf of the BIE. It sought comprehensive information on companies' Australian as well as overseas operations; in particular, motives for their initial investment decisions. It covered 225 firms, of which 111 (49 per cent) were engaged in manufacturing, 102 (45 per cent) were in the service sector and 7 (3 per cent) were in the primary sector.

For manufacturing firms, the three dominant motives (in order of importance) for overseas investment were:

- to take advantage of the expected growth in the host country market;
- to utilise patents, know-how or expertise developed in Australia; and
- to protect existing export markets.

These three motives were also the dominant ones cited by service sector firms. However, protecting existing export markets was slightly more important to service sector firms than the use of patents, know-how or expertise developed in Australia.

The survey also provided details about motives classified by regions. It found that:

- lower unit costs were far more important for firms investing in Asia than in any other region;
- overcoming tariff barriers (which were more prevalent at that time) was relatively more important in New Zealand than other regions; and
- making use of patents and expertise was important in all regions.

APPENDIX D: INDUSTRY COMMISSION SURVEY OF OFFSHORE INVESTMENT

This appendix presents the results from a Commission survey of Australian offshore investment. It outlines the purpose of the survey, the methodology adopted and the response rate obtained, as well as summarising the survey results disaggregated by sector. A copy of the survey questionnaire is attached to this appendix.

D.1 Introduction

Initial investigation by the Commission indicated a paucity of information on one of the major issues on which the inquiry was required to report — the impact of companies' offshore activities on the Australian economy. To help overcome this shortcoming, the Commission conducted a survey of manufacturing, mining and service sector firms in mid-December 1995.

As no comprehensive listing of firms with offshore operations was available, the Commission sought the assistance of the Minerals Council of Australia, the Business Council of Australia, the Metal Trades Industry Association, the Australian Chamber of Commerce and industry to help identify firms which have offshore operations.

The survey questionnaire was developed internally after consultation with the ABS. It was designed in a simple format so that it could be completed by senior executives relatively quickly and without undue effort. The questionnaire was sent to key people, in most cases CEOs, in the respective organisations. The Commission engaged the ABS to process, edit and validate the responses.

The response to the survey was high, with several respondents commenting on the design and 'user friendly' nature of the survey. The questionnaire was dispatched to 402 firms in Australia, of which 299 responded. This represented a response rate of 74 percent (see Table D.1). Of these, 148 firms had direct investments overseas (79 manufacturing, 54 service sector and 15 mining firms). Most (52 per cent) were large firms with employment in Australia exceeding 1000 persons. The market value of the combined overseas assets of the responding companies was $170 billion.

D.2 Summary of results

The results presented below mainly reflect the number of firms falling into each category, with no allowance made for differences in firm size. All percentages are based on the total number of respondents, which is 148 unless otherwise specified (see Table D.2).

Response rate

Table D.1: Overall response rate

	Dispatched	*Response*	*Firms with ADIA*	*Firms with no ADIA*
Number	402	299	148	151
Percentage	100	74.4	36.8	37.8

Company details

Table D.2: Main production/service activities undertaken offshore

Sector	*No. of responses*	*%*
Manufacturing	79	53
Mining	15	10
Services	54	37
TOTAL	148	100

Table D.3: Firms' employment in Australia (percentage)

Establishment size	*M'facturing*	*Mining*	*Services*	*All sectors*
1-49	2	6	0	2
50-99	8	0	7	7
100-499	24	27	21	23
500-999	13	0	24	16
1000 or more	53	67	48	52
TOTAL	100	100	100	100

Table D.4: Firms' employment offshore (percentage)

Establishment size	*M'facturing*	*Mining*	*Services*	*All sectors*
1-49	18	13	43	26
50-99	13	13	9	11
100-499	34	20	20	28
500-999	7	7	11	9
1000 or more	28	47	17	26
TOTAL	100	100	100	100

Nature of offshore operations

Table D.5: Nature of offshore operations relative to operations in Australia[a] (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
Similar to core domestic operations	89	100	70	83
Related upstream	3	7	2	3
Related downstream	14	20	7	12
Sales/service	20	13	37	26
Different from core domestic activity	3	7	2	3

a Because of multiple responses, percentages exceed 100.

Table D.6: Market value of assets involved in offshore operations ($billion)

Sector	*Market value*
Manufacturing	20.52
Mining	76.53
Services	72.90
TOTAL	169.95

Table D.7: Proportion of firms' total investment in offshore operations (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
< 25 per cent	62	67	86	71
25 to 50 per cent	27	27	7	20
Over 50 per cent	11	6	7	9
TOTAL	100	100	100	100

Table D.8: Region(s) of investment[a] (percentage)

Region	*M'facturing*	*Mining*	*Service*	*All sectors*
New Zealand	59	47	65	60
Asia	78	73	74	76
United Kingdom	20	20	30	24
Other European	20	27	13	18
North America	41	40	33	38
Other	19	60	15	22

a Because of multiple responses, percentages exceed 100.

Government influences on offshore location

Table D.9: Factors subject to Australian government control which influenced firms to undertake offshore operations[a] (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
None	62	33	85	68
Labour market policies	18	20	4	13
Taxation arrangements	18	20	6	14
Declining tariffs on output/tariffs on inputs	23	7	2	14
Competition policy	18	13	6	13
Other	18	53	7	18

a Because of multiple responses, percentages exceed 100.

Table D.10: Most important Australian government factor (ranked 1) which influenced firms to undertake offshore operations (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Labour market policies	6	0	2	4
Taxation arrangements	4	20	4	5
Declining tariffs on output/tariffs on inputs	13	0	0	7
Competition policy	8	13	4	7
Other	8	33	6	10
None	62	33	85	68
TOTAL	100	100	100	100

Table D.11: Factors subject to foreign government control which influenced firms to undertake offshore operations[a] (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
None	48	47	69	55
Tax incentives	35	40	7	26
Tariff barriers	30	27	7	22
Other	30	53	28	32

a Because of multiple responses, percentages exceed 100.

Table D.12: Most important offshore government factor (ranked 1) which influenced firms to undertake offshore operations (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Tax incentives	19	27	2	14
Tariff barriers	16	0	2	9
Other	16	27	28	22
None	48	47	69	55
TOTAL	100	100	100	100

Table D.13: Importance of factors subject to Australian government control relative to 'commercial factors'[a] (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Very important	10	13	4	8
Important	14	20	7	12
Some importance	18	27	21	20
Not important	32	20	33	31
Not relevant	26	20	35	29
TOTAL	100	100	100	100

a Commercial factors include market demand-related influences (such as growth opportunities) as well as cost advantages.

Table D.14: Importance of factors subject to offshore government control relative to 'commercial factors'[a] (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Very important	22	7	17	18
Important	14	13	19	16
Some importance	27	60	22	29
Not important	22	7	22	20
Not relevant	15	13	20	17
TOTAL	100	100	100	100

a Commercial factors include market demand-related influences (such as growth opportunities) as well as cost advantages.

Effects of offshore operations

Table D.15: Effect of offshore operations on the value of companies' production in Australia[a] (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Large decrease	10	0	0	5
Small decrease	17	0	2	10
No change	45	80	45	49
Small increase	24	13	40	29
Large increase	4	7	13	7
TOTAL	100	100	100	100

a Total number of responses equals 147.

Table D.16: Effect of offshore operations on the value of companies' investment in Australia (percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Large decrease	10	14	0	7
Small decrease	15	33	7	14
No change	52	33	59	53
Small increase	17	20	28	21
Large increase	6	0	6	5
TOTAL	100	100	100	100

Table D.17: Effect of offshore operations on companies' employment in Australia
(percentage)

Category	*M'facturing*	*Mining*	*Service*	*All sectors*
Large decrease	5	7	0	3
Small decrease	18	20	6	14
No change	51	53	50	51
Small increase	24	13	38	28
Large increase	2	7	6	4
TOTAL	100	100	100	100

Table D.18: Compositional change of companies' workforce in Australia as a result of offshore operations – Summary
(percentage)

Response	*M'facturing*	*Mining*	*Service*	*All sectors*
No change	61	87	69	66
Yes (some change)[a]	39	13	31	34
TOTAL	100	100	100	100

a Refer to Tables D.19 to D.21 for further details.

Table D.19: Compositional change of companies' workforce in Australia as a result of offshore operations – Manufacturing[a]
(percentage points)

Category	*Employment*			
	Increase	*Decrease*	*No change*	*Total*[b]
R&D/engineering	22	6	11	39
Skilled production	6	13	20	39
Semi-skilled production	5	15	19	39
Marketing/sales	14	6	19	39
Management/administration	16	6	16	39
Other	1	0	10	11

a Multiple responses.

b Not all respondents who reported a compositional change in their workforce (see Table D.18) reported a change for all categories. Some rows do not add to totals due to rounding.

Table D.20: Compositional change of companies' workforce in Australia as a result of offshore operations – Mining[a] (percentage points)[b]

Category	*Employment*			
	Increase	*Decrease*	*No change*	*Total*[c]
R&D/engineering	7	7	0	13
Skilled production	0	7	7	13
Semi-skilled production	0	7	7	13
Marketing/sales	7	7	0	13
Management/administration	7	7	0	13
Other	0	7	0	7

a Multiple responses.
b Results are statistically insignificant.
c Not all respondents who reported a compositional change in their workforce (see Table D.18) reported a change for all categories. Some rows do not add to totals due to rounding.

Table D.21: Compositional change of companies' workforce in Australia as a result of offshore operations – Services[a] (percentage points)

Category	*Employment*			
	Increase	*Decrease*	*No change*	*Total*[b]
R&D/engineering	9	2	19	30
Skilled production	11	0	19	30
Semi-skilled production	6	0	24	30
Marketing/sales	17	0	13	30
Management/administration	22	4	6	31
Other	6	2	7	15

a Multiple responses.
b Not all respondents who reported a compositional change in their workforce (see Table D.18) reported a change for all categories. Some rows do not add to totals due to rounding.

Table D.22: Effect of offshore operations on the value of companies' exports from Australia[a] (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
Large decrease	3	0	2	2
Small decrease	18	7	4	12
No change	30	67	21	30
Small increase	35	13	50	39
Large increase	14	13	23	17
TOTAL	100	100	100	100

a Total number of responses equals 146.

Table D.23: Compositional change in companies' exports from Australia[a] (percentage)

Response	*M'facturing*	*Mining*	*Services*	*All sectors*
Yes (a change)	29	13	19	24
No change	71	87	81	76
TOTAL	100	100	100	100

a Total number of responses equals 144.

Table D.24: Proportion of goods/services offshore companies purchase from their own or other companies in Australia[a] (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
None	20	13	4	14
<25 per cent	65	73	58	63
25-50 per cent	5	7	13	8
Over 50 per cent	10	7	25	15
TOTAL	100	100	100	100

a Total number of responses equals 147.

Table D.25: Influence of other Australian companies on the decision to establish offshore operations (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
Not applicable	78	80	61	72
By suppliers of raw materials	1	0	2	1
By suppliers of service and other inputs	0	0	2	1
By firms using your product/service	13	13	13	13
By competitors	5	7	15	9
Other	3	0	7	4
TOTAL	100	100	100	100

Table D.26: Offshore operations encouraging other Australian companies to invest in the same country (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
Not applicable	74	47	67	68
Attracted firms supplying raw materials to your offshore operations	4	0	0	2
Attracted firms supplying services and other inputs to your offshore operations	5	13	5	6
Attracted firms using your product/service	1	0	0	1
Attracted competitors	15	33	26	21
Other	1	7	2	2
TOTAL	100	100	100	100

Table D.27: Effect of offshore operations on company imports into Australia[a] (percentage)

Category	M'facturing	Mining	Services	All sectors
Large decrease	0	0	0	0
Small decrease	2	0	0	1
No change	71	100	81	78
Small increase	19	0	13	15
Large increase	8	0	6	6
TOTAL	100	100	100	100

a Total number of responses equals 147.

Table D.28: Areas in which Australian operations gained technological or related benefits as a result of offshore operations[a] (percentage)

Category	M'facturing	Mining	Services	All sectors
None	53	40	46	49
Research and development	30	27	26	28
Production/process technologies	32	47	20	29
Strategic planning and finance	9	20	17	13
Administration	6	7	6	6
Marketing	20	33	31	26

a Because of multiple responses, percentages exceed 100.

Table D.29: Effect of offshore operations on overall company profitability[a] (percentage)

Category	M'facturing	Mining	Services	All sectors
Large decrease	4	13	4	5
Small decrease	15	0	17	14
No change	10	13	6	9
Small increase	44	47	56	49
Large increase	27	27	17	23
TOTAL	100	100	100	100

a Total number of responses equals 147.

Table D.30: Approximate proportion of offshore profits repatriated to Australia[a] (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
<25 per cent	65	61	62	63
25-50 per cent	8	13	9	10
51-75 per cent	3	13	6	5
Over 75 per cent	24	13	23	22
TOTAL	100	100	100	100

a Total number of responses equals 147.

Table D.31: Problems encountered in repatriating profits to Australia (percentage)

Category	*M'facturing*	*Mining*	*Services*	*All sectors*
None	67	60	59	63
Foreign government restrictions	21	27	20	21
Australian tax policy	6	0	15	9
Other	6	13	6	7
TOTAL	100	100	100	100

INDUSTRY COMMISSION

Survey of Australian Offshore Investment

Information about this brief questionnaire

The survey form can be completed for an enterprise group or part of your enterprise group.

Confidentiality	All information provided in this form will be treated as strictly **confidential.** Only aggregated data will be published.
Definitions	Offshore investment (or 'foreign direct investment') is defined as investments in overseas enterprises in which your company has a significant influence *and* owns not less than 10 per cent of the ordinary shares or voting stock. The survey does not cover portfolio investment.
Queries	Any inquiries about this questionnaire can be addressed to: Alan Johnston (06) 240 3245 or Abdul Waris (06) 240 3232.
Return date	Please return the completed questionnaire in the envelope provided to Industry Commission, PO Box 80, BELCONNEN ACT 2616 or by fax to (06) 240 3311 by **15 December 1995**.

If your company does not have foreign direct investment — as defined above — please tick the following box and return this cover page (after completing contact details) in the envelope provided or by fax to (06) 240 3311.

❑ **No foreign direct investments**

Person the Commission should contact with any queries regarding this survey return.

Company: ________________________________

Contact Person: ________________________________

Telephone: ________________________________

CONFIDENTIAL

Part A: Company details

1. Does this survey return relate to the activities of the:

Enterprise group as a whole ☐1
Part of the enterprise group ☐2 ➔ Please specify:

2. What are the main production/service activities undertaken offshore?

List up to three

....
....
....

Office use

3. How many people do you employ in Australia and offshore?

Tick one box in each column

	Australia	Offshore
1 to 49	☐1	☐1
50 to 99	☐2	☐2
100 to 499	☐3	☐3
500 to 999	☐4	☐4
1000 or more	☐5	☐5

Part B: Nature of offshore operations

4. What is the nature of your offshore operations <u>relative</u> to your operations in Australia?

Tick more than one box as applicable

Similar to core domestic operations ☐1
Related upstream (eg raw materials) ☐2
Related downstream
(eg finishing/value-adding) ☐3
Sales/Service ☐4
Different from core activities ☐5 ➔ Please specify:

5. What is the approximate market value of the assets involved in your offshore operations?

A$m...............

6. Approximately what proportion of your total investment is in offshore operations?

Tick one box

(per cent)
Less than 25 ☐1
25 to 50 ☐2
Over 50 ☐3

7. In which region(s) have you invested?

Tick more than one box as applicable

New Zealand ☐1
Asia ☐2
UK ☐3
Other European ☐4
North America ☐5
Other ☐6 ➔ Please specify:

Part C: Government influence on offshore location

8. Rank those factors subject to Australian government control which influenced your decision to undertake offshore operations.

Rank most important as 1, 2, 3 etc.

None ☐1 ➔ Go to question **9**
Labour market policies ☐2
Taxation arrangements ☐3
Declining tariffs on output/tariffs on inputs ☐4
Competition policy ☐5
Other (eg regulations) ☐6 ↓

Please specify:

9. Rank those factors subject to <u>foreign</u> government control which influenced your decision to undertake offshore operations.

Rank most important as 1, 2, 3 etc.

None ☐1 ➔ Go to question **10**
Tax incentives ☐2
Tariff barriers ☐3
Other (eg regulations, financial incentives, political strategy, developed legal systems) ☐4 ↓

Please specify:

10. In your decision to invest offshore, how important were factors subject to Australian <u>and</u> offshore government control relative to 'commercial' factors[1]?

Tick one box in each column

	Australia	Offshore
Very important	☐1	☐1
Important	☐2	☐2
Some importance	☐3	☐3
Not important	☐4	☐4
Not relevant	☐5	☐5

1. Note: Commercial factors include growth opportunities, cost advantages, proximity to customers and lower labour and freight costs.

Part D: Effects of offshore operations

11. What effect have your offshore operations had on the value of your production and investment in Australia?

Tick one box in each column

	Production	Investment
Large decrease	☐ 1	☐ 1
Small decrease	☐ 2	☐ 2
No change	☐ 3	☐ 3
Small increase	☐ 4	☐ 4
Large increase	☐ 5	☐ 5

12. What effect have your offshore operations had on your employment in Australia?

Tick one box

Large decrease ☐ 1
Small decrease ☐ 2
No change ☐ 3
Small increase ☐ 4
Large increase ☐ 5

13. Has there been a change in the composition of your workforce in Australia as a result of offshore operations?

No ☐ ➔ Go to question **15**
Yes ☐ ➔ Go to question **14**

14. How has the composition of your workforce in Australia changed?

Tick one box in each row

(staff)	Increase	Decrease	No Change
R&D/engineering	☐1	☐2	☐3
Skilled production	☐1	☐2	☐3
Semi-skilled production	☐1	☐2	☐3
Marketing/sales	☐1	☐2	☐3
Management/administration	☐1	☐2	☐3
Other	☐1	☐2	☐3

15. What effect have your offshore operations had on the value of your exports <u>from</u> Australia?

Tick one box

Large decrease ☐1
Small decrease ☐2
No change ☐3
Small increase ☐4
Large increase ☐5

16. Has there been any change in the composition of your exports <u>from</u> Australia?

No ☐1
Yes ☐2

Please specify:

17. What proportion of goods/services do your offshore operations purchase from your own business or other companies in Australia?

Tick one box

(per cent)

None ☐1
Less than 25 ☐2
25 to 50 ☐3
Over 50 ☐4

18. Was your decision to establish offshore operations influenced by the offshore location of <u>other</u> Australian companies?

Tick one box

Not applicable ☐1
By suppliers of raw materials ☐2
By suppliers of service and other inputs ☐3
By firms using your product/service ☐4
By competitors ☐5
Other ☐6

Please specify:

19. Have your offshore operations encouraged other Australian companies to invest in the same country?

Tick one box

Not applicable ☐1
Attracted firms supplying raw materials to your offshore operations ☐2
Attracted firms supplying services and other inputs to your offshore operations ☐3
Attracted firms using your product/service ☐4
Attracted competitors ☐5
Other ☐6

Please specify:

20. What effect have your offshore operations had on the level of your <u>imports</u> into Australia?

Tick one box

Large decrease ☐ 1
Small decrease ☐ 2
No change ☐ 3
Small increase ☐ 4
Large increase ☐ 5

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21. In which areas have your operations in Australia gained technological or related benefits as a result of your offshore operations?

Tick more than one box as applicable

None ☐ 1
Research and development ☐ 2
Production/process technologies ☐ 3
Strategic planning and finance ☐ 4
Administration ☐ 5
Marketing ☐ 6

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22. What effect have your offshore operations had on your overall profitability?

Tick one box

Large decrease ☐ 1
Small decrease ☐ 2
No change ☐ 3
Small increase ☐ 4
Large increase ☐ 5

23. Approximately what proportion of your offshore profits has been repatriated to Australia?

Tick one box

(per cent)	
Less than 25	☐ 1
25 to 50	☐ 2
51 to 75	☐ 3
Over 75	☐ 4

24. Do your offshore operations encounter problems repatriating profits to Australia ?

Tick one box

None	☐ 1
Foreign government restrictions	☐ 2
Australian tax policy	☐ 3
Other	☐ 4

Please specify:

THANK YOU FOR COMPLETING THIS FORM

APPENDIX E: SURVEY OF EMPIRICAL STUDIES ON THE IMPACTS OF OFFSHORE INVESTMENT

This appendix reviews the empirical literature dealing with the economic effects on the home country of foreign investment abroad. It draws on earlier reviews of the literature by the United Nations (UN 1993a), Gunderson and Verma (1994), Hufbauer, Lakdawalla and Malani (1994) and the BIE (1995f).

As noted in Chapters 2 and 4, the main problems are a lack of published data below the ASIC division level, especially over time, and an inability to relate the foreign investment data to other data collected for Australian multinationals (for example, that relating to employment and investment). To help overcome these problems, the Commission conducted a survey designed to provide a broad indication of the economic effects of foreign investment at the firm level. The Commission also undertook an econometric study to examine the effects of ADIA on the economy as a whole (see Appendix F).

In drawing on other empirical studies to assess the effects of ADIA, the Commission has taken into account the significant variations in the quality of the studies. Owing to a variety of methodological limitations and deficiencies (discussed in the next section), the findings of many studies are questionable or at least require careful interpretation as to what conclusions can be validly drawn. The attachment to this appendix summarises the empirical studies reviewed by the Commission, classified according to their estimated effects on trade, employment and investment.

E.1 Methodologies

In the empirical literature surveyed, the three key methodological differences relate to:

- the benchmark against which the effects are measured (the ‘counterfactual’);
- the level of aggregation at which the study is undertaken (firm, industry or economy); and
- the techniques used to measure the economic effects.

The 'counterfactual'

In order to measure the economic effects, there needs to be some understanding of what would have happened in the absence of foreign investment. This is known as the counterfactual and represents the main reason why the findings of the empirical literature differ (see Box E.1).

The empirical literature, either explicitly or implicitly, assumes one of three counterfactuals:

- Some studies (for example, the 'inference' studies discussed below) simply assume that *all* offshore investment would have taken place domestically.
- To the extent that it is feasible (given differences in production and transport costs), some labour market studies assume that foreign markets for manufactured goods can be served through exports.
- The bulk of the empirical literature measures the impacts against the state of the world before investment occurred. Implicitly, these studies assume that the funds used in the offshore investment would have been put to their prior use had the overseas investment not taken place.

Level of aggregation

The second difference in methodology relates to the level of aggregation used. Firm-level studies capture the effects of foreign investment on the investing firm. They do not tell us much, however, about the effects external to the investing firm. Some studies purport to give economy-wide effects, but measure these against an artificially assumed counterfactual, rather than against a realistic alternative state of the economy. This is a feature of all the studies that measure employment effects, although a few of the trade studies estimate genuine economy-wide effects.

Analytical technique

Finally, studies differ in the techniques they use. The first, and most common approach, is the use of econometrics. Other techniques include economic models, surveys, 'inference' methods and statistical techniques. Each approach has its own strengths and weaknesses. The tables in the attachment summarise the major findings of each study and indicate the technique and the level of aggregation used.

Box E.1: The importance of the 'counterfactual'

It is difficult to measure the economic effects of foreign investment, partly because it is difficult to determine what would have happened in its absence. To what extent would the investing firm have supplied foreign markets through exports? If it did, would it have been able to survive in the long term? Would the firm have invested the money domestically, either in a similar project or in an unrelated one? Each option results in a different set of measured economic effects.

In economics, the choice of benchmark against which to assess what would have happened is known as the 'counterfactual'. As a hypothetical illustration, suppose that a company relocated its entire operations offshore, with the loss of 100 jobs. The effect on domestic unemployment would depend on what would have happened if the investment had not occurred. If the firm could have supplied foreign markets through exports, then unemployment would be 100 higher than it would otherwise have been without the foreign investment. However, if the firm would not have survived in the long-term, those people would have become unemployed anyway. In this case, long-term unemployment would not be any higher than it would have been had foreign investment not occurred.

A number of broad counterfactuals exist in assessing the effects of offshore investment:

- some or all of the foreign market could be supplied through Australian exports;
- a foreign firm could make an investment overseas, displacing Australian exports;
- the Australian firm could licence a foreign firm to supply foreign markets;
- the Australian firm could sell the ownership rights to a foreign firm;
- the Australian firm could invest in another project within Australia, either in the same industry or another industry; and/or
- the firm could use the funds that it would have invested offshore in some other way (for example, by increasing dividends).

Most studies use published data that detail the levels of particular variables at a given point in time. They do not take into account what would have happened in the absence of foreign investment. If an alternative counterfactual is used, the study has to make some assumptions concerning what would have happened. The conclusions are often sensitive to the assumptions employed.

Econometric studies

Most of the studies reviewed assess the effects of foreign investment using econometric techniques to establish the relationship between foreign investment and other key economic variables of interest (for example, exports and employment). The majority look at the effect on industries or economies. However, some American and Swedish studies consider the effects on individual firms.

The econometric studies typically estimate the relationship between the domestic impact under consideration (for example, investment), foreign investment and other factors that may explain that impact (for example, real interest rates and national income).

The primary strength of the econometric studies is their rigour. If done correctly, they are capable of isolating the impact of foreign investment from other possible causes in a statistically robust manner. In addition, many of the studies capture effects external to the firm. Many of the possible limitations associated with econometric techniques, including the choice of counterfactual and the quality of the available data, are shared with other techniques.

In principle, with sufficient data, the econometric studies could also capture dynamic effects. However, no econometric study relating to foreign investment does this. Instead, they measure effects at a given point in time.

Nearly all of the studies relate to other countries (for example, the United States, Japan and Sweden). As the industrial bases of these countries differ from Australia, this may limit their applicability.

Economic models

A number of studies use economic or mathematical models to analyse the effects of foreign investment. These are more complex than the econometric studies and are capable of picking up many of the interactions that exist within an economy. This enables them to capture many of the indirect effects associated with foreign investment, such as the effect on input suppliers.

These techniques allow a richer range of responses than do most econometric studies. However, many of their parameter values are not determined econometrically and are either assumed or inferred from other data. Consequently, the findings of economic modelling can be viewed as being only broadly indicative of the effects of foreign investment.

Firm-level surveys

Surveys are a good way of identifying a wide range of firm-level effects at a given point in time (for example, domestic employment, investment, trade and technological, managerial and administrative impacts). Their firm-level nature makes it easier for the respondent to separate the effects associated with foreign investment from those attributable to other external factors than is possible in the aggregate studies.

Another advantage of firm-level studies is that it is possible to target the major foreign investors. This, however, comes at the expense of some loss of generality as their findings may not be applicable to all foreign investors (for example, BIE 1995f).

Unlike some of the econometric studies, surveys fail to capture any effects external to the firm. Depending on the nature of the investment, these may or may not be significant.

Inference studies

A number of studies looking at the effects of foreign investment employ what can loosely be called ‘inference’ techniques. They use relatively crude statistical measures to look at the direct impacts of foreign investment on employment (for example, Cypher 1992; Faux and Spriggs 1991; Koechlin and Larudee 1992; and Prestowitz et al. 1991). Although their methodologies are broadly similar, each study has its own nuances.

The key distinction between inference and other studies is that they explicitly assume, rather than estimate, a counterfactual — that all funds are invested domestically — and their findings flow directly from this assumption. Thus, they essentially assume the answer to the question that other studies seek to test. Given this serious deficiency, the Commission has not placed any weight on their findings, although they have been included in the tables for the sake of completeness.

Statistical studies

A number of studies use a variety of simple statistical techniques. Some studies use graphs to plot various impacts against foreign investment, either across industries or through time (for example, Howe 1994; Ries and Head 1994; and Yetton, Davis and Swan 1992). Lipsey (1994) compares the characteristics of the parent firm and their foreign subsidiaries. Brainard (1993b) calculates firm-level averages using data for American multinationals from the United States Department of Commerce. Rao, Legault and Ahmad (1994) estimate impact elasticities using the change in exports and foreign investment. Horst (1976) uses a variety of techniques.

Two Australian statistical studies (Howe 1994 and Yetton, Davis and Swan 1992) use industry-level data (two-digit ASIC) published by the ABS for the manufacturing sector. The data have been subsequently revised, but are not available for publication. Thus, it is not possible to establish whether their findings still apply.

The statistical techniques employed are capable of showing the association between particular impacts and foreign investment. However, they do not prove a causal link and are incapable of isolating the effects of foreign investment from other possible causes (for example, the business cycle).

E.2 Economic effects

While the literature assesses certain economic effects of foreign investment, it does not generally estimate the effects on national income. The mere presence of a statistical relationship, as reported in this appendix, does not imply a change in national income. However, it is possible to draw some inferences concerning the possible income effects from the limited discussion of the effects on wages, employment, profitability and investment.

The empirical literature deals with the impact of foreign investment on four key areas: the rate of return to foreign investment; trade; employment; and investment. (Chapter 4 discusses the limited number of studies dealing with the effects on production and technological spillovers associated with foreign investment.)

Rates of return

The BIE (1995f) found the average rate of return earned overseas by Australian manufacturing firms in 1993–94 was 5.6 per cent, lower than the 8.8 per cent they earned domestically. Service firms, however, earned a higher return overseas than they did at home. Both groups expect to earn a higher rate overseas than they will at home over the five year period to 1999. A majority of respondents to the Commission’s survey (72 per cent) found that foreign investment increased their profitability. This result was fairly uniform across sectors.

A number of American empirical studies find that profitability and foreign investment are positively related. That is, firms undertaking foreign investment tend to be more profitable than similar domestic firms (for example, Cohen 1972; Pagoulatos and Sorensen 1976; Bergsten, Horst and Moran 1978; Hirschey 1982; and Benvignati 1983). After controlling for other possible influences, Bergsten, Horst and Moran (1978) found the earnings of multinational corporations to be 5 to 8 percentage points higher than similar domestic firms. They concluded that foreign investment strengthens domestic market power because it enables the firms to achieve greater vertical integration (utilising cheap labour and/or raw materials), spread joint costs across a larger base, diversify portfolios across different economies and markets, and reduce tax liabilities (Bergsten, Horst and Moran 1978, pp. 234-6).

A group of studies (for example, Hufbauer and Alder 1968; Reddaway et al. 1967, 1968; and Shepherd, Silberston and Strange 1985) explore the time taken for the income flows from foreign investment to cover the net cost to the project. Although somewhat dated, these studies found that it takes 9 to 12 years on average for the investment to generate a positive net return (UN 1993a). These studies ignored the indirect effects, except for the exports of capital associated with the initial investment.

Trade effects

There is a common view that foreign investment essentially involves exporting domestic jobs. In most cases, this view is predicated on the assumption that foreign markets can be successfully supplied from the home country through exports. As indicated in Chapter 4, the trade effects associated with foreign investment are more complex. For example, foreign investment in the non-traded goods sector is unlikely, by definition, to affect exports or imports of the services provided.[1]

The empirical trade literature deals with the effect of foreign investment on exports, imports and the balance of trade.

Exports

The industry-level econometric and statistical studies that assess the effect of foreign investment on exports (see Table E.4 in the attachment) find an overwhelmingly positive relationship between foreign investment and exports (for example, Blomström, Kokko and Zejan 1994; Blomström, Lipsey and Kulchycky 1988; Brainard 1993b; Lipsey and Weiss 1981; Rao, Legault and Ahmad 1994; and Yamawaki 1991). That is not to say that some displacement may not occur, just that the induced exports more than offset the effects. The

[1] Technically, trade in services can occur, but basically this requires direct contact between buyer and seller.

economy-wide study of Hufbauer, Lakdawalla and Malani (1994) came to a similar conclusion. However, the findings of the Australian studies (Howe 1994 and Yetton, Davis and Swan 1992) are inconclusive.

In contrast, two industry-level studies, Frank and Freeman (1978) and Glickman and Woodward (1989), estimate the extent to which American exports could supply foreign markets. Both compared the difference in the (variable) cost of production at home and abroad, taking into account the cost of transportation and the sensitivity of foreign demand to any change in prices.[2] However, they did not detail how differences in international production costs at the industry level were derived and whether these differences were sensitive to the point in time chosen. They found that American foreign investment had, to varying extents, had a negative impact on exports by manufacturing industries (see Table E.1). The study found that foreign markets could be better served through American exports in the paper, rubber, chemicals and other manufacturing industries, while it was more difficult for the transportation equipment and metal industries. In addition, Frank and Freeman (1978) indicated that the possibility of servicing foreign markets through exports may be greater the more market power the company has in the foreign markets.

Most of the firm-level studies, especially the econometric and Australian studies, come to a similar conclusion as their industry-level counterparts — that foreign investment increases total exports (for example, the Commission's own survey; Edwards 1994; Lipsey and Weiss 1984; McKinsey and Co. 1993; and Swedenborg 1979, 1982, 1985).

However, some firm-level studies find that foreign markets can be serviced through exports (for example, Edwards and Buckley 1995; Shepherd, Silberston and Strange 1985; and Svensson 1993). For example, Shepherd, Silberston and Strange (1985) found that approximately half of the British firms surveyed could have supplied foreign markets to some extent through exports. Svensson (1993) found that a US$100 increase in Swedish foreign investment reduced exports by the Swedish parent company by US$14. Exporting is likely to be more viable the closer the markets are to the home country (Edwards and Buckley 1995).

Foreign investment may change the composition of exports. Ries and Head (1994) found a positive relationship between Japanese foreign investment and the share of electrical equipment in total Japanese exports, and a negative relationship with textiles and transport equipment. However, they failed to isolate the effects attributable to foreign investment from those arising from

[2] Glickman and Woodward (1989, Appendix C) provide a more detailed explanation of the methodology used.

other factors within the Japanese economy (for example, changes to Japanese comparative advantage). However, the Commission's survey indicated that foreign investment had little or no effect on the composition of firm-level exports (76 per cent of respondents).

The literature does not differentiate between the effects of investment in sales and distributional facilities and production facilities. However, at a more disaggregated level, the empirical literature unanimously finds that foreign investment has a positive effect on one-off exports of capital and other inputs used in establishing foreign subsidiaries and on exports of raw materials and processed intermediate inputs on a continuing basis (for example, Lipsey and Weiss 1984 and Svensson 1993).

One study which looked at the effect on third country exports found that foreign investment had a negative impact on firm-level exports to third countries, with US$100 worth of foreign investment reducing Swedish exports to third countries by US$42 (Svensson 1993).

Table E.1: Export substitution parameters, United States, 1970[a,b] (per cent)

Food	36.8
Chemicals	44.1
Primary and fabricated metals	24.5
Electrical machinery	34.5
Non-electrical machinery	35.8
Transportation equipment	19.1
Rubber	46.3
Paper	46.3
Other manufacturing	40.2

a Share of existing overseas markets capable of being supplied through exports.
b Converted to percentages by multiplying by 100.
Source: Frank and Freeman 1978.

Little empirical research addresses the dynamic effect on exports and, even then, only in a rudimentary manner. Edwards and Buckley (1995) suggested that Australian foreign investment, in the first instance, may replace firm-level exports. Over time, they found that exports increased as foreign investment helped firms to achieve greater market penetration than they could have achieved through exporting. Shepherd, Silberston and Strange (1985) came to a similar conclusion. They doubted whether exporting would be sustainable in the long run in the presence of foreign competitors taking up the profitable opportunities forgone overseas. Bergsten, Horst and Moran (1978), however, found the converse at the industry level — that the short-term effects are more beneficial than those in the long term. Such an explanation is consistent with the notion that firms may source their inputs initially from known suppliers in the home country (including the parent company), but in the longer term seek out more competitive suppliers.

A Canadian study by Rao, Legault and Ahmad (1994) found that the elasticity of exports to the stock of Canadian outward foreign investment (CDIA) had fallen over time for all manufacturing industries. Over the period 1971–80, a one per cent change in the stock of CDIA led to a 1.02 per cent increase in all industry exports (see Table E.2). Although still positive, this elasticity fell to 0.48 over the period 1981–89.

Table E.2: Elasticities of exports to the stock of foreign investment, Canada, 1971 to 1989

Major industry grouping	*Exports to CDIA[a] stock*	
	1971–80	*1981–89*
Manufacturing	1.12	0.67
Primary metals	1.03	0.48
Wood and paper	1.06	0.41
Chemicals	0.95	0.36
All industries	1.02	0.48

a Canadian direct investment abroad.
Source: Rao, Legault and Ahmad 1994.

Imports

By comparison with the large number of studies focusing on the effect of foreign investment on exports, relatively few studies focus on the impact on foreign investment on imports. Brainard (1993b) and Hufbauer, Lakdawalla and Malani (1994) found a weakly positive relationship between imports and foreign investment (see Table E.5 in the attachment). Figure 13 in (Howe 1994) indicates a similar weakly positive relationship for Australia. About 21 per cent of respondents to the Commission’s survey indicated that their offshore operations had increased their imports into Australia. In addition, another 78 per cent of firms indicated that their imports had not changed. However, unlike some of the export-oriented studies, the available studies do not differentiate between the categories of goods being imported (for example, intermediate inputs and finished goods).

Balance of trade

Although far from conclusive, the empirical evidence indicates that, if any thing, foreign investment tends to improve the balance of trade or net export performance — that is, the effect on exports exceeds that on imports (see Table E.6 in the attachment). Yamawaki (1991) found a positive relationship for Japan, as did Hufbauer, Lakdawalla and Malani (1994) for the United States. Conversely, Brainard (1993b) found a negative relationship for the United States, as did Hufbauer, Lakdawalla and Malani (1994) for Japan. For Germany, Hufbauer, Lakdawalla and Malani (1994) found that the relationship has gone from being negative to positive over time, although these results were less robust than those for Japan and the United States.

Shepherd, Silberston and Strange (1985) found it difficult to draw an overall conclusion about the impact of foreign investment on trade from their survey of British multinational enterprises, beyond the fact that foreign investment results in higher value-added exports.

Employment effects

Following the establishment of the North American Free Trade Agreement (NAFTA), there was significant concern in North America about the relationship between foreign investment and employment. The American and Canadian public held widespread concerns that the introduction of free trade would lead to the export of labour-intensive jobs to Mexico, where labour is cheaper. These concerns fuelled substantial research on the relationship between foreign investment and the labour market. Buckley and Artisien (1987) undertook similar research on labour market issues in Europe following the creation of the European Community.

Total employment

The empirical literature acknowledges that foreign investment simultaneously creates and displaces domestic employment across the economy (see Table E.7 in the attachment). The overall impact depends upon the relative strengths of these two countervailing effects. Those studies indicating that foreign investment enhances domestic employment (for example, Lipsey and Weiss 1981) find that the ‘job creation’ effect exceeds the ‘job displacement’ effect.

Other studies find a negative impact (for example, Glickman and Woodward 1989). However, many of the techniques used are incapable of separately measuring these effects. Those studies that do measure these relative effects suffer from other methodological deficiencies that cast significant doubt over their findings.

Most of the American studies assume that, in the absence of foreign investment, *all* of the funds invested overseas would have been invested in the United States (for example, Cypher 1992; Faux and Spriggs 1991; Koechlin and Larudee 1992; and Prestowitz et al. 1991). As a direct result of this assumption, these studies find adverse employment effects. The more rigorous of these studies test the sensitivity of their findings to the key assumptions used (for example, the share of foreign production destined for the home market). Their findings are sensitive to the values used — in many cases changing an apparent loss to a gain (for example, Hawkins 1972; Prestowitz et al. 1991; and United States Tariff Commission 1973). Another study, Edwards (1994), used survey evidence to establish a positive relationship between Australian exports to the United Kingdom and Australian foreign investment, and then used this to draw conclusions concerning the effects on domestic employment. Lipsey and Weiss (1981) drew a similar employment conclusions for the United States from their econometric work on trade.

Where foreign investment opens up new markets or increases existing markets, the firm-level employment effects are clearly positive (Buckley and Artisien 1987). This conclusion is consistent with the findings of the Commission's survey and Lipsey (1994). The Commission's survey found the strongest employment gains were in the services sector, while Lipsey (1994) found that the employment effect for non-manufacturing industries was positive.

The employment implications for manufacturing industries are integrally related to the trade effects. Where foreign investment complements domestic exports, domestic employment is likely to be higher than it would otherwise have been. This link has not been proven conclusively. Using a small sample, Buckley and Artisien (1987) concluded that, where foreign investment complements trade, there is no discernible effect on domestic employment. Where foreign investment replaces domestic exports, the employment effects are clearly negative (for example, Buckley and Artisien 1987; Frank and Freeman 1978; and Glickman and Woodward 1989). However, none of these studies address the issue of whether exporting can be sustained in the long term. If exporting could not be sustained, unemployment would have occurred anyway, albeit at some future date.

Time profile

Labour market adjustment is a dynamic process. However, from an empirical point of view, virtually all of the studies estimate the effects on a static basis. For example, they measure the total number of jobs created or lost over a given period of time. An American study, by Frank and Freeman (1978), is a notable exception, though now dated.

The dynamics of labour markets are not generally well understood. Even when they are understood, it is difficult to apply their findings across time when domestic economic conditions may be different and, in particular, to countries with significantly different institutional arrangements and industrial bases. For example, American labour markets operate with far fewer institutional constraints than their Australian counterparts, and the industrial bases of the two countries are different.

Bearing these comments in mind, Frank and Freeman (1978) explored the dynamics of labour market adjustment to American outward foreign investment in 1970. They found that the resulting unemployment was a transitory phenomenon with most displaced workers within each industry finding jobs within seven weeks. Even for the non-electrical machinery industry, the industry with the largest initial job displacement and the most seriously persistent unemployment problems, 80 per cent of displaced workers found new jobs within 14 weeks. The study found that protracted periods of unemployment were not one of the major effects associated with the transfer of production activities overseas. Thus, the adjustment process may be more important than the initial unemployment. However, given the significant differences that exist between the state of the American labour market in the study and the Australian market today, it is not clear to what extent these conclusions apply to Australia today.

Wages

The empirical literature sheds little light on the effect of offshore investment on wage levels and the share of national income accruing to labour. In a dated American study, Musgrave (1975), using a neoclassical framework, found that foreign investment raised the domestic return to capital and lowered the return to labour (reported in UN 1993a). Another American study by Frank and Freeman (1978) came to similar conclusion. However, their findings were significantly influenced by the large amount of taxation revenue America forgoes on income earned overseas by American companies.[3] Thus, it is

[3] Musgrave's findings may be similarly influenced by American taxation policy.

impossible to separate the effects of foreign investment from the effects of American taxation policy.

Employment composition

The limited studies (see Table E.8 in the attachment) find that foreign investment benefits, or affects less adversely, the demand for skilled, relative to less skilled, labour (for example, Frank and Freeman 1978 and Lipsey 1994). This suggests that those employed performing head office functions (so called 'white collar' jobs) gain relative to production workers (so called 'blue collar' jobs). Even within 'blue collar' occupations, foreign investment seems to favour the more skilled (see Table E.3).

These findings differ somewhat from the Commission's own survey. Only 34 per cent of respondents indicated a change in the composition of domestic employment. Where a change did occur, service firms recorded an almost across-the-board increase in average skill levels. This is understandable given the nature of their operations. However, for manufacturing firms, there tended to be an increase in the proportion of workers employed in head office functions (R&D, engineering, marketing, sales, management and administration) and a decrease in skilled and semi-skilled production.

Domestic investment

The BIE (1995f) found a statistically significant positive relationship between Australian foreign and domestic investment at the firm level (see Table E.9 in the attachment). Table E.9 They found that each dollar of net foreign investment increased domestic investment by approximately one dollar (BIE 1995f, p. 167), but their results are likely to be biased because of omitted variables. Noorzoy (1980) came to a similar conclusion using economy-wide data for the United States. The Commission's survey results, however, were more muted. Overall, foreign investment had no effect on domestic investment for 53 per cent of firms. The remaining respondents were equally divided (26 per cent recorded an increase in domestic investment, while 21 per cent record a decrease). At the industry level, the relationship tended, if anything, to be positive for service firms, but negative for mining firms.

Table E.3: Employment demand reduction ratios, United States, 1970[a]

Occupation category	*Per cent*
White collar:	
Professional, technical and kindred	0.195
Managers, officials and proprietors	0.141
Clerical and kindred	0.171
Sales workers	0.106
Total white collar	0.164
Blue collar:	
Craftspersons, forepersons and kindred	0.289
Operatives	0.357
Labourers (except farm and mine)	0.169
Total blue collar	0.307
Service workers	0.088
Farmers and farm workers	0.134
Total manufacturing	0.203

a The ratio of the change in employment arising from foreign investment to the 1970 employment level.
Source: Frank and Freeman 1978.

Feldstein (1994a) estimated the relationship between domestic investment, national savings and both outward and inward foreign investment, together with other possible explanatory factors (for example, inflation and short-term interest rates as a proxy for portfolio investment) for 18 OECD countries throughout the 1970s and 1980s. He found that outward foreign investment reduced domestic investment by an equal amount, and this was not offset by an increase in international portfolio investment. Given that the equation he estimates is essentially an identity, although the magnitude and sign of the individual coefficients are free to vary, his results may be subject to simultaneity biases. However, the paper does not provide information to ascertain whether these biases are present.

Belderbos (1992) found a similar negative relationship for the Netherlands.

In contrast, Rao, Legault and Ahmad (1994) found a positive and statistically significant relationship (using econometric techniques) between domestic and foreign investment for Germany, Japan and the United Kingdom. For Canada and the United States, their estimates were statistically insignificant.

In contrast to the findings of Feldstein and Belderbos, those of Rao, Legault and Ahmad are consistent with those dealing with the impacts on trade. Depending on the level of capacity utilisation, an increase in exports would tend, if it had any effect at all, to be associated with higher levels of domestic investment, not lower. A number of studies (for example, Lipsey 1994 and Lipsey and Weiss 1984) found a positive link between foreign investment and exporting, before proceeding to assert that this translated into an increase in domestic investment. In surveying the literature, Blomström and Kokko (1994) used a similar line of reasoning.

Attachment

The following tables summarise the empirical literature relating to foreign investment by area of impact.

Table E.4: Effect of direct foreign investment on home country exports[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Bergsten, Horst and Moran	1978	United States	Econometric (cross-section) (industry level)	Positive (short-term) No effect (long-term)	Initial overseas investment promotes exports of American products. However, over time, foreign investment becomes less and less of a complement and more and more of a substitute for American exports.
Blomström, Lipsey and Kulchycky	1988	Sweden	Econometric (cross-section) (industry level)	Positive	Swedish foreign investment complements Swedish exports at the industry level.
Blomström, Lipsey and Kulchycky	1988	United States	Econometric (cross-section) (industry level)	Mostly positive	American foreign investment generally, but not always, complements American exports at the industry level.
Blomström, Kokko and Zejan	1994	Mexico (host country)	Econometric (cross-section) (industry level)	Positive	There is a statistically significant and positive relationship between technology imports of foreign affiliates (that is, exports from the home country) and foreign investment.
Brainard	1993b	United States	Statistical (industry level)	Positive	On average, US$100 of sales by foreign affiliates owned by American parents generates US$13 of American exports.
Edwards	1994	Australia	Survey (20 firms)	Positive	Australian foreign investment complements exports to the United Kingdom by sponsoring a flow of raw materials, components and finished goods to foreign subsidiaries.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

Table E.4 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Edwards and Buckley	1995	Australia	Survey (38 firms)	Negative (if FDI replaces exports) Possibly positive (if FDI increases the share of foreign markets) Positive (intermediate inputs)	Australian subsidiaries in the United Kingdom replaced exports with local production because of transport costs and expanding sales volumes. Australian firms are more likely to export to Thailand and Malaysia, but this may decline over time. Exports could increase if foreign investment allowed their market share to increase significantly.
Frank and Freeman	1978	United States	Economic model (cross-section) (industry level)	Negative (manufacturing)	For all nine American manufacturing industries studied, foreign markets could have been supplied through exports, although the extent varies significantly between industries. Exporting is most viable for the *Chemicals* and *Paper* industries and least viable for the *Transport equipment* and *Primary and fabricated metals* industries.
Glickman and Woodward	1989	United States	Economic model (industry level)	Negative (manufacturing)	All manufacturing industries could have supplied foreign markets through exports.
Horst	1976	United States	Statistical (firm level)	No effect, but possibly weakly positive	Some evidence that a modest amount of foreign investment might be a prerequisite to exporting. Otherwise, there was no clear evidence of a link between foreign investment and exporting.

Table E.4 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Howe	1994	Australia	Statistical (industry level)	No effect	Overall, no systematic association is found between the change in Australian foreign investment and the share of manufacturing exports. However for the *textiles*, *clothing and footwear*, *paper products*, and the *other machinery and equipment* industries a positive relationship is found.
Hufbauer, Lakdawalla and Malani	1994	Germany	Econometric (cross-section) (economy-wide)	Weakly positive	Foreign investment and exports are complementary and statistically significant in two of the three equations.
Hufbauer, Lakdawalla and Malani	1994	Japan	Econometric (cross-section) (economy-wide)	Positive	In the Japanese export equations, the coefficients are positive and significant in all years.
Hufbauer, Lakdawalla and Malani	1994	United States	Econometric (cross-section) (economy-wide)	Positive	In the export equations for the United States, the coefficients are positive and significant in all years.
Industry Commission	1996	Australia	Survey (148 firms)	Positive	A majority of respondents (56 per cent overall) said that they experienced an increase in the value of their exports compared to 14 per cent report a reduction in the value of their exports. Service and manufacturing firms recorded the largest net increase. Most respondents (76 per cent) indicated no change in the composition of exports.

Table E.4 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Ishimine	1978	Japan	Survey (1 128 firms)	Positive	Japanese foreign subsidiaries source 47.4 per cent of their inputs from Japan.
Lipsey and Weiss	1981	United States	Econometric (cross-section) (industry level)	Positive	Consistently found that the level of sales by American manufacturing affiliates is positively related to American exports.
Lipsey and Weiss	1984	United States	Econometric (cross-section) (firm level)	Positive	Where statistically significant, foreign production complements exports of both intermediate goods and finished products. These effects are not uniform across all industries.
McKinsey and Co.	1993	Australia	Survey (317 firms)	Positive	90 per cent of respondents indicated that offshore production had no effect or increased exports.
Rao, Legault and Ahmad	1994	Canada	Statistical (industry level)	Positive	A 10 per cent increase in foreign investment increased Canadian exports across all industries by 4.8 per cent.
Ries and Head	1994	Japan	Statistical and econometric (firm level)	Mostly positive	Generally, they found a positive relationship between foreign investment and exports. However, the effect may be negative for some industries (for example, textiles).
Shepherd, Silberston and Strange	1985	United Kingdom	Survey (23 firms)	Weakly negative	Half of the respondents indicated that exporting would have been a viable option had overseas production not occurred, but resulting sales would only have been a fraction of overseas production.

Table E.4 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Svensson[b]	1993	Sweden	Survey (unknown)	Negative	The exports of intermediate goods promoted by foreign investment do not offset the loss of finished good exports. Overall, a US$100 increase in foreign production reduces Swedish exports by the parent by US$14.
Swedenborg[c]	1979 and 1982	Sweden	Econometric (cross-section) (firm level)	Positive	US$100 of foreign production increases total exports by US$10 — the net effect of a US$12 increase in exports by affiliated companies and a US$2 loss in exports by non-affiliates.
Swedenborg	1985	Sweden	Econometric (cross-section) (firm level)	Positive	Multinational sales (that is, foreign investment) complement exports by manufacturing affiliates, but substitutes for the exports of other firms.
Yamawaki	1991	Japan	Econometric (cross-section) (industry level)	Positive	Japanese foreign investment in distributional activities promotes Japanese exports.
Yetton, Davis and Swan	1992	Australia	Statistical and survey (150 firms[d])	Equivocal	Industry level data indicates that foreign investment complements exports, but this linkage tends to disappear using more disaggregated data. The effect on exports varies between firms.

b Quoted in Lipsey 1994.

c Quoted in Hufbauer, Lakdawalla and Malani 1994.

d Sample includes an undisclosed number of domestic firms.

Table E.5: Effect of direct foreign investment on home country imports[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Brainard	1993b	United States	Statistical (industry level)	Positive	On average, US$100 of sales by foreign affiliate owned by American parents generates US$15 of American imports.
Howe	1994	Australia	Statistical (industry level)	Positive	Overall, foreign investment and imports are complementary.
Hufbauer, Lakdawalla and Malani	1994	Germany	Econometric (cross-section) (economy-wide)	No effect	Generally, German foreign investment was not found to affect German imports. However, the effect declines over time.
Hufbauer, Lakdawalla and Malani	1994	Japan	Econometric (cross-section) (economy-wide)	Positive	Japanese foreign investment and imports are positively related and statistically significant in all years studied. In 1990, US$100 worth of foreign investment increased Japanese imports by US$36.
Hufbauer, Lakdawalla and Malani	1994	United States	Econometric (cross-section) (economy-wide)	No effect	Generally, American foreign investment was not found to affect American imports.
Industry Commission	1996	Australia	Survey (148 firms)	No effect	Most respondents (78 per cent) indicated no change in the level of imports following foreign investment. However, most of the remaining respondents said they would increase slightly (15 per cent).
Ishimine	1978	Japan	Survey (1 128 firms)	Positive	Japanese foreign subsidiaries sell 19 per cent of their output to Japan.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

Table E.6: Effect of direct foreign investment on the home country balance of trade[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Brainard	1993b	United States	Statistical (cross-section) (industry level)	Negative	US$100 of sales by foreign affiliate owned by American parents generate US$2 of American net imports.
Hufbauer, Lakdawalla and Malani	1994	Germany	Econometric (cross-section) (economy-wide)	Equivocal	Over time, the net trade effect has gone from negative to positive. However, the results are less robust than the Japanese or American results.
Hufbauer, Lakdawalla and Malani	1994	Japan	Econometric (cross-section) (economy-wide)	Negative	Japanese foreign investment tends to increase imports more than exports.
Hufbauer, Lakdawalla and Malani	1994	United States	Econometric (cross-section) (economy-wide)	Positive	American foreign investment increases exports more than imports.
Yamawaki	1991	Japan	Econometric (cross-sectional) (industry level)	Positive	American distribution subsidiaries strongly promote net Japanese exports to the United States.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

Table E.7: Effect of direct foreign investment on the level of home country employment[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Buckley and Artisien	1987	European Community	Survey (19 firms)	Negative (if FDI replaces exports) No effect (if FDI complements exports) Positive (if FDI occurs in new markets)	The effect varies between firms depending on the nature of the investment. The dynamic effects on employment are inconclusive.
Cypher[b]	1992	United States	Inference (economy-wide)	Negative	The relocation of American investment to Mexico following the creation of NAFTA (estimated to be US$17 000 million over 5 years) is expected to lead to an annual loss of 222 058 jobs (39 501 from the foregone investment and 182 557 resulting from increased imports by the United States).
Faux and Spriggs[b]	1991	United States	Inference (economy-wide)	Negative	The relocation of American investment to Mexico following the creation of NAFTA (estimated to be US$44 000 million to the year 2000) is expected to lead to a total loss of 1 264 000 jobs.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

b Quoted in Gunderson and Verma 1994.

Table E.7 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Frank and Freeman	1978	United States	Economic model (industry level)	Negative (short-term) No effect (long-term)	American manufacturing foreign investment results in short-term unemployment as foreign markets could have been supplied, to varying extents, through exports. This effect, however, is a transitory, rather than a permanent, phenomenon.
Glickman and Woodward	1989	United States	Economic model (industry level)	Negative	American foreign investment is estimated to have cost 2.7 million manufacturing jobs (net) between 1977 and 1986 — creating 588 000 jobs and replacing 3.3 million jobs.
Hawkins[c]	1972	United States	Inference (economy-wide)	Equivocal	The estimated net employment effect of American foreign investment in 1970 ranges from a loss of 600 000 potential jobs to a gain of 240 000 jobs depending on the assumptions used.
Industry Commission	1996	Australia	Survey (148 firms)	Weakly positive	Most firms indicated that domestic employment remains unchanged or increases with foreign investment. The increase is more pronounced for services than for manufacturing.
Koechlin and Larudee[b]	1992	United States	Inference (economy-wide)	Negative	The relocation of American investment to Mexico following the creation of NAFTA (estimated to be between US$3.5 and US$5 900 million) is expected to lead to an annual loss of between 29 000 and 54 000 jobs.

b Quoted in Gunderson and Verma 1994.

c Quoted in United Nations 1993a.

Table E.7 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Lipsey	1994	United States	Econometric (cross-section) (firm level)	Negative (in aggregate) Positive (non-manufacturing) Negative (manufacturing)	On average, US$1 million worth of affiliate production reduces parent company employment by 0.77 employees. For manufacturing and non-manufacturing affiliates, the corresponding numbers were a loss of 1.38 employees and a gain of 1.2 employees.
Prestowitz et al.[b]	1991	United States	Inference (economy-wide)	Equivocal	The long-term employment effect of American investment to Mexico following the creation of NAFTA (estimated to increase by US$25 000 million by the year 1999) ranges from a gain of 264 000 jobs to a loss of 900 000 jobs by 1999, depending on the assumptions used.
Shepherd, Silberston and Strange	1985	United Kingdom	Survey (23 firms)	Negative	Additional domestic employment would have resulted if foreign investment had not have taken place. Half of the firms survived could have viably supplied foreign markets through exports.
United States Tariff Commission[b]	1970	United States	Inference (economy-wide)	Equivocal	The estimated net employment effect of American foreign investment in the 1960s ranges from a loss of 1.3 million potential jobs to a gain of 500 000 jobs, depending on the assumptions used.

b Quoted in Gunderson and Verma 1994.

Table E.8: Effect of direct foreign investment on the composition of home country employment[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Frank and Freeman	1978	United States	Economic model (industry level)	Skill enhancing	Foreign investment enhances relative skills by having a bigger impact on less skilled occupations.
Industry Commission	1996	Australia	Survey (146 firms)	No effect or skill enhancing	Most firms (66 per cent) indicated that foreign investment had no effect on the composition of employment. For manufacturing, it led to an increase in head office jobs and a reduction in production jobs.
Lipsey	1994	United States	Statistical (firm level)	Skill enhancing	Parent companies have a higher proportion of total employment in R&D than do affiliates. Foreign investment results in a compositional change in employment towards more managerial and technical employment.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

Table E.9: Effect of direct foreign investment on home country investment[a]

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Belderbos	1992	Netherlands	Econometrics (pooled) (industry level)	Negative	Foreign investment and domestic investment by Dutch multinationals are negatively related and statistically significant
BIE	1995f	Australia	Econometric (cross-section) (firm level)	Positive	Statistically significant positive amd one-for-one relationship between domestic investment and overseas investment.
Feldstein	1994a	OECD (18 countries)	Econometrics (pooled) (economy-wide)	Negative	Each dollar of cross-border flow of foreign investment reduces domestic investment by approximately one dollar.
Industry Commission	1996	Australia	Survey (148 firms)	No effect	Overall, most respondents (53 per cent) indicated that foreign investment had no effect on domestic investment. However, foreign investment had a clearly negative impact for mining firms and a slightly positive impact for service firms.
Noorzoy	1980	United States	Econometric (time series) (economy wide)	Positive	American direct investment abroad is complementary to domestic business investment.
Rao, Legault and Ahmad	1994	Canada	Econometric (time series) (industry level)	No effect	No statistically significant relationship between foreign investment and domestic gross fixed capital stock.

a Many of these studies suffer from methodological deficiencies and therefore require careful interpretation — see accompanying text.

Table E.9 (continued):

Study	*Year*	*Country*	*Nature of study*	*Effect*	*Finding*
Rao, Legault and Ahmad	1994	Germany	Econometric (time series) (industry level)	Positive	Positive and statistically significant relationship between foreign investment and domestic gross fixed capital stock.
Rao, Legault and Ahmad	1994	Japan	Econometric (time series) (industry level)	Positive	Positive and statistically significant relationship between foreign investment and domestic gross capital formation.
Rao, Legault and Ahmad	1994	United Kingdom	Econometric (time series) (industry level)	Positive	Positive and statistically significant relationship between foreign investment and domestic gross fixed capital stock.
Rao, Legault and Ahmad	1994	United States	Econometric (time series) (industry level)	No effect	No statistically significant relationship between foreign investment and domestic gross fixed capital stock.
Stevens and Lipsey[b]	1992	United States	Econometric (time series) (firm level)	Negative	An increase in foreign output leads to a reduction in domestic investment.

b Quoted in Lipsey 1994.

APPENDIX F: ECONOMETRIC ESTIMATION OF THE IMPACT OF ADIA

In reviewing the available empirical literature on the domestic impacts of outward foreign investment, the Commission found only a limited number of Australian studies (see Appendix E). The studies generally concluded that Australian foreign investment does not have any detrimental effect on domestic activity. However, most studies used firm-level survey data to measure the impact of foreign investment on the firm undertaking the investment (for example, BIE 1995f, Buckley and Edwards 1995, and Edwards 1994). They do not capture effects that occur outside the firm. Thus, their findings may not be representative of the effects on the economy as a whole. The remaining Australian studies use graphical techniques to establish the impact of ADIA at the industry level (Howe 1994 and Yetton, Davis and Swan 1992). As a result, they do not test the statistical significance of their findings.

Data limitations have precluded a comprehensive analysis of the economic impacts of ADIA (for example, the effect of ADIA on tax revenue). However, this appendix uses econometric techniques to estimate the principal effects associated with ADIA — on exports, imports, investment, employment and output — that were identified in the survey of the empirical literature (see Appendix E).[1] Apart from problems with the quality of the data, the main limitation with this approach is that it identifies only a statistical association and not any causality.[2]

F.1 Methodology

The more rigorous of the econometric studies identified in Appendix E take account of factors apart from ADIA that may influence domestic activity. The Commission's analysis has likewise sought to identify other possible influences, as a failure to do so may bias the econometric results.[3] A wide range of possible

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1 The Commission also unsuccessfully attempted to estimate the effect of ADIA on real wages. However, the centralised nature of wage determination in Australia over the sample period meant that the estimated equations did a poor job of explaining real wages.

2 Chapter 2 discusses the quality of ADIA data published by the ABS.

3 Similarly, the inclusion of irrelevant variables may also bias the results. For a more detailed discussion of the econometric problems associated with model mis-specification, see, for example, Maddala (1993).

explanatory variables were canvassed, drawn from the theoretical and empirical literature (Appendix E) and from two Australian macroeconomic models, TRYM (Taplin et al. 1993) and the Murphy model (Powell and Murphy 1995).

Techniques

This study looks at the impact of ADIA over the period 1969–70 to 1993–94.[4] It was not possible to extend the period covered as data relating to many of the key variables, most notably ADIA, are not available for longer periods.[5]

For each of the five variables analysed (exports, imports, investment, employment and output), the following generalised model was estimated:

$$Domestic\ impact = f\left(ADIA, other\ possible\ explanatory\ factors\right) \qquad (1)$$

Table F.1 lists the variables tested in each equation. The preferred model was estimated using general-to-specific estimation techniques, based on the t statistics, adjusted coefficient of determination ($\bar{R}^2$), the Durbin-Watson statistic and the Phillips-Perron test for cointegration. Where necessary, ADIA then was reintroduced into the preferred model to indicate the direction of its effect.

Earlier econometric studies have found that generalised Cobb-Douglas production functions (also called log linear production functions) can explain satisfactorily movements in Australian output (for example, Chand 1995, IC 1995b, and Otto and Voss 1994). This appendix estimates all equations in log linear form. The only variables entered in level terms were the real Australian interest rate and the real interest rate differential.

A key issue in this inquiry has been the degree to which ADIA substitutes for, or complements, investment in Australia. At the firm-level, ADIA may possibly occur at the expense of another project in Australia. However, it is not clear whether any relationship at the firm-level will hold across the entire economy. The Commission sought to test this proposition by identifying those factors which affect investment in Australia by Australians (termed domestic Australian investment in this appendix). This differs from what is commonly viewed as domestic investment as it excludes investment by foreign residents in Australia (inward foreign direct investment, or FDI). That is not to say that inward FDI may not influence domestic Australian investment or any of the other variables

4 The sample period covers the substantial increase in Australian foreign investment which occurred in the mid-1980s (see Chapter 2).

5 Some components of ADIA are available from 1947–48.

under consideration. To test the importance of FDI, it has been included as one of the many possible explanatory variables in all of the equations.

Table F.1: Economy-wide econometric models estimated[a]

Domestic variable	*Explanatory variables tested*
Non-rural exports[b]	ADIA, inward FDI, price of non-rural exports, real exchange rate, transport costs, world GDP and index of world openness
Imports	ADIA, inward FDI, Australian GDP, effective rate of protection, real exchange rate and price of imports
Domestic Australian investment	ADIA, inward FDI, age of the private capital stock, Australian GDP, price of investment, real interest rate differential, public capital stock and Tobin's Q
Employment	ADIA, inward FDI, Australian GDP, Australian interest rates, hours worked, human capital, private capital stock and real unit labour costs
Output	ADIA, inward FDI, employment, human capital, private capital stock, public capital stock and terms of trade

a Besides the variables listed in the table, a constant, time trend and three dummy variables also were included in each of the equations.

b At the sectoral level, the price of non-rural exports was replaced by the corresponding price of sectoral exports. International visitor numbers also were included in the services equation.

Rural exports have been excluded for two reasons. Firstly, agriculture accounts for little or no ADIA, yet the sector accounts for a significant proportion of Australian exports (see Table B.5).[6] Rural exports are unlikely to be affected significantly by ADIA in other sectors. Secondly, the trend rate of growth for agricultural exports (in constant prices) over the sample period is considerably lower than that for non-rural exports. Thus, the factors determining rural exports are likely to differ from those explaining non-rural exports.

In line with advances in time series econometrics over the past decade, each variable was tested to see whether it was stationary and each equation was tested to see whether it formed a cointegrating relationship (that is, whether there was a long-run 'equilibrium' relationship among the variables). All the variables tested were found to be integrated of order one. In such circumstances, standard statistical inferences used (including t-statistics) are invalid. However, they have been used to undertake the general-to-specific methodology. The preferred specification was then reestimated using the Johansen procedure and

6 In 1994, ADIA by the Agriculture, forestry, fishing and hunting industry (ASIC division A) was negligible.

inferences about the significance of ADIA were cross-checked using maximum likelihood ratio tests, which are valid with non-stationary data.

The equations estimated should be viewed as portraying long-run relationships as they do not capture the short-term dynamics of the adjustment process.

The equations were estimated separately, rather than as a system of simultaneous equations. This may introduce some simultaneity bias into the results as some of the variables being explained, in turn, may explain other variables. (For example, output might affect employment and employment might affect output.) On this subject, Rao and Miller (1971) said that:

> It is widely believed that whenever the model is simultaneous in nature, the use of single-equation estimation procedure necessarily yields "bad" estimates. This is not always the case. True, the single-equation procedure yields biased estimates of the parameters; but so do all the others in small samples. In some situations it may happen that single-equation estimation procedures are "better" than the simultaneous-equations estimation procedures, even though the true model involves simultaneous equations (p. 185).

F.2 Data

Table F.2 summarises the data used. It describes each variable, the units in which they are measured and the source of the data. Where it was necessary to convert data from current to constant prices, the table also lists the deflators used.

The principal source of the Australian data was the ABS.[7] Other published sources included the Reserve Bank of Australia's *Bulletin*, the Commonwealth Treasury's *Economic Round-up*, the Industry Commission's manufacturing database (IC 1995d) and the International Monetary Fund's *International Financial Statistics Yearbook* (IMF 1995). The Commonwealth Treasury provided unpublished data on Tobin's Q.

[7] Some of the ABS data were obtained from the dX database and the Reserve Bank's historical series (RBA 1991).

Table F.2: Description and source of data used[a,b]

Variable	*Description*	*Source(s)*
ADIA	Australian direct investment abroad (ADIA) *Deflator:* Implicit price deflator, non-dwelling construction and equipment GFCE[c] *Units:* A$ million (1989–90 prices)	ABS (various) 5363.0
Age of the private capital stock	Average age of the gross capital stock – private enterprises *Units:* Years	ABS (various) 5221.0
Australian GDP	Gross domestic product (GDP(E)) *Units:* A$ million (1989–90 prices)	dX 5206-1
Australian real interest rates	Real long-term Australian Government bond yield (not logged) *Deflator:* Rate of change in the Australian GDP deflator *Units:* Percentage	IMF (1995)
Domestic Australian investment	Private gross fixed capital expenditure on non-dwelling construction and equipment *less* Foreign direct investment in Australia *Deflator:* Price of investment (see below) *Units:* A$ million (1989–90 prices)	ABS (various) 5204.0 ABS (various) 5221.0
Dummy variable – ADIA adjustment	Dummy variable indicating that the negative net flow ADIA in 1990–91 was replaced by a small positive number so that natural logarithms could be taken 1 = adjusted, 0 = not adjusted	Not applicable
Dummy variable – ADIA valuation technique	Dummy variable indicating change in ADIA valuation technique used by the ABS 1 = historical cost, 0 = current values	Not applicable
Dummy variable – ADIA ownership level	Dummy variable indicating the change in the level of ownership used by the ABS to be classified as direct investment 1 = 25 per cent, 0 = 10 per cent	Not applicable
Effective rate of protection	Average effective rate of protection for Australian manufacturing *Units:* Percentage	IC (1995d)
Employment	Total number of persons employed *Units:* Persons (000s)	dX 6202-1 dX 6202-H1

a All variables are for Australia unless otherwise stated.

b The absence of a deflator indicates that the data were obtained in constant prices or non-monetary units.

c The GDP deflator also was used as a deflator to test the sensitivity of the results to the deflator used.

Table F.2 (continued):

Variable	*Description*	*Source(s)*
Exports – non-rural	Total exports of goods and services *less* Total rural exports *Deflator:* Price of exports – non-rural (see below) *Units:* A$ million (1989–90 prices)	ABS (various) 5410.0 RBA (1991)
Exports – mining	Total exports – mining *Deflator:* Price of exports – mining (see below) *Units:* A$ million (1989–90 prices)	ABS (various) 5410.0
Exports – manufacturing	Total exports – manufacturing *Deflator:* Price of exports – manufacturing (see below) *Units:* A$ million (1989–90 prices)	ABS (various) 5410.0
Exports – services	Services: Credits: Total *Units:* A$ million (1989–90 prices)	dX 5302-24
FDI	Foreign direct investment in Australia (flow) *Deflator:* Implicit price deflator, non-dwelling construction and equipment GFCE *Units:* A$ million (1989–90 prices)	ABS (various) 5363.0
Hours worked	Average hours worked per employee per week *Units:* Hours per week	dX 6203-B RBA (1988)
Human capital	Skilled labour (professionals, technical and related, administration and managerial staff) as a percentage of total employment *Units:* Percentage	ABS (various) 6101.0 ABS (various) 6204.0
Imports	Imports of goods and services *Deflator:* Implicit price deflator, Imports of goods and services *Units:* A$ million (1989–90 prices)	ABS (various) 5410.0 dX 5302-12 RBA (1991, 1995)
International visitors	Short-term arrivals: Overseas visitors (annual) *Units:* Persons	dX 3401-1
Price of exports – non-rural	Terms of trade – exports *less* Export price index – agriculture weighted by the relative value of agricultural exports *Units:* Index (1989–90=100.0)	*Calculated from:* ABS (various) 5410.0 dX 6405-5 RBA (1991, 1995)
Price of exports – mining	Implicit export price deflator – mining *Units:* Index (1989–90=100.0)	ABARE (1993)
Price of exports – manufacturing	Export price index – manufacturing *Units:* Index (1989–90=100.0)	dX 6405-5

Table F.2 (continued):

Variable	*Description*	*Source(s)*
Price of exports – services	Implicit export price deflator, Service – Credits *Units:* Index (1989–90=100.0)	dX 5302-7
Price of imports	Terms of trade – imports *Units:* Index (1989–90=100.0)	RBA (1991, 1995)
Price of investment	Implicit price deflator, non-dwelling construction and equipment GFCE *Units:* Index (1989–90=100.0)	*Calculated from:* ABS (various) 5204.0 ABS (various) 5221.0
Private capital stock	End of year, net capital stock – private enterprises *Units:* A$ million (1989–90 prices)	ABS (various) 5221.0 RBA (1991)
Public capital stock	End of year, net capital stock – public authorities *Units:* A$ million (1989–90 prices)	ABS (various) 5221.0 RBA (1991)
Real effective exchange rate	Nominal trade weighted exchange rate adjusted for the inflation differential between Australia and its major trading partners *Units:* Index (1970=100.0)	ABARE (1995)
Real interest rate differential	Real long-term Australian Government bond yield *less* Real long-term US Government bond yield (not logged) *Deflators:* Rates of change in the Australian and US GDP deflators *Units:* Percentage points	*Calculated from:* IMF (1995)
Real unit labour costs	Real unit labour costs *Units:* Index (Ave 1966–67 to 1972–73 =100.0)	Treasury (various)
Terms of trade	Ratio of exports price to import price of goods and services *Units:* Index (1989–90=100.0)	RBA (1991, 1995)
Tobin’s Q	Ratio of the rate of return on capital to the cost of funds *Units:* Ratio	Treasury (unpublished)
Transport costs	Ratio of the value of total Australian imports CIF to imports FOB *Units:* Index (1989–90=100.0)	IMF (1995)
World GDP	Total world gross domestic product *Units:* A$ million (1987 prices)	dX, World Bank Tables T.08
World openness	Weighted average of total exports plus imports to gross domestic product for Japan, the United States and the United Kingdom *Units:* Percentage	*Calculated from:* dX, World Bank Tables (various)

All of the variables included in equation 1 were expressed in constant prices (as opposed to current prices) to eliminate the effects of price changes over time. As the ABS does not publish constant price estimates of ADIA, the Commission constructed a time series of constant price ADIA. This study uses the domestic investment deflator (price of investment), so that the constant price ADIA series measures the real domestic investment equivalent of a given nominal stream of ADIA. However, the Australian GDP deflator also was used to test the sensitivity of the results to the choice of deflator. As the results were not sensitive to the choice of deflator, the results using the GDP deflator are not discussed.

The ADIA and FDI variables used are the *flows* of ADIA and FDI, as the ABS publishes ADIA stock data only since 1979–80. More precisely, they are *net flows* (outflows net of repatriations by Australian residents).

In 1985–86, the ABS changed the methodology for collecting ADIA and FDI data. Before 1985–86, an equity stake of 25 per cent or more was required for overseas investment to be classified as direct investment. Assets were valued at paid-up value (historical cost), rather than current market values. In 1985–86, the equity stake needed was revised to 10 per cent and assets were valued at current market values. In 1985–86, the ABS revised its previous estimates of ADIA and FDI data back to 1980–81 to incorporate the new valuation technique. However, the data were not revised to take account of the lower level of ownership.[8] Two dummy variables were included in all equations to test the significance of these changes. One dummy variable captures the change in the asset valuation technique from 1979–80 onwards. The second dummy variable captures the change in the ownership level needed for foreign investment from 1985–86 onwards.

Besides the Australian data, some international data were used. World GDP (in constant prices) was obtained from the World Bank tables of the dX database. US real interest rates were used as a proxy for world interest rates and the share-weighted sum of exports and imports to GDP for three of Australia's major trading partners — Japan, the United States and the United Kingdom — as a proxy for worldwide openness to trade. The real effective exchange rate was included to pick up movements in relative prices between Australian and its trading partners.

8 In its submission to the draft report, the ABS stated that "the change in definition had an impact on foreign direct investment in Australia, but the impact on ADIA was negligible" (Sub. 39, p. 3).

F.3 Results

As noted, general-to-specific estimation techniques were used in estimating each of the equations set out in Table F.1. The economy-wide results are presented in Tables F.3 and F.4.

Non-rural exports

Australia's non-rural exports were found to be positively related to world GDP and the openness of the economies of our major trading partners, and negatively related to the Australian dollar price of non-rural exports (see Table F.3). The inclusion of a time trend in the preferred model indicates that the level of Australian exports has increased over time.

ADIA was found to have a positive influence on the aggregate level of Australia's non-rural exports. However, the t and LR tests indicated that ADIA failed to add explanatory power to the equation.

FDI, transport costs and the real effective exchange rate were also eliminated from the preferred model.

The high adjusted R^2 indicates that the estimated equation is a good fit, and the Durbin-Watson indicates the absence of autocorrelation. The presence of a cointegrating relationship indicates a long-run relationship between the variables.

Sectoral decomposition of non-rural exports

The exclusion of ADIA in the preferred model of aggregate exports might be occurring in sectors of the economy where trade is not possible or practical (for example, in most service industries). The Commission sought to establish whether the effect on exports differed between the mining, manufacturing and tradable service sectors. For data availability reasons, the sample was restricted to 1976–77 to 1992–93. The results are shown in Table F.5.

For mining, manufacturing and tradeable services, ADIA had a positive effect on Australian exports.[9] The magnitude of these effects is greater than for non-rural exports as a whole, but non-rural exports include some non-traded service exports that are unlikely to be affected by ADIA.

Apart from the impact of ADIA on exports, some other minor differences exist in the sectoral results. Australia's mining exports have moved in line with world output (world GDP) and the opening up of our trading partners' economies has

9 The Johansen procedure could not be followed at the sectoral level because of the limited number of degrees of freedom available.

increased manufactured exports. For mining, the sign on the openness variable appears counterintuitive, but the data indicate that the Japanese trade share of GDP, which is a major destination for Australian mineral exports, is declining over time. The strong growth in tourism (international visitors) underlies much of the increase in service exports.

All equations appear statistically sound with high adjusted R^2 and acceptable Durbin-Watson statistics.

In summary, the econometric results indicate that lagged ADIA has a positive impact on aggregate non-rural exports, although ADIA fails to add explanatory power to the preferred model. At the sectoral level, ADIA has a positive effect on mining, manufacturing and service exports.

Imports

The main factor driving Australian imports is Australian income (Australian GDP) (see Table F.3). The estimated coefficient indicates that demand is highly sensitive to income. Price is also a determinant of imports, with demand being inversely related to price. The real exchange rate is also an important influence on the demand for imports. As an appreciation of the real exchange rate makes imports cheaper relative to equivalent Australian products, the demand for imports increases with the real exchange rate. There is a negative relationship between the level of imports into Australia and the effective rate of protection offered to Australian industry.

The LR statistic indicates that ADIA adds significant explanatory power to the preferred model. The coefficient indicates that a one per cent increase in ADIA increases imports by 0.081 per cent. The firm-level surveys and other anecdotal evidence suggest that the impact of ADIA on imports may be smaller than that indicated here.[10] The coefficient on ADIA may be capturing in part the effect of some factor or factors outside the model and whose growth coincides with the increase in ADIA over the 1980s.[11]

No statistical relationship was found between inwards FDI and imports into Australia.

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[10] The survey evidence (see, for example, Appendices C and D) indicates that most ADIA is undertaken to supply foreign markets and is similar to that undertaken in Australia. However, some (albeit small) quantity of ADIA is undertaken to supply the Australian market (for example, certain textiles, clothing and footwear manufacturers).

[11] For example, Australian imports may have increased because of the deregulation of Australian capital markets.

The estimated equation is statistically robust. It has a high adjusted R^2 and a good Durbin-Watson statistic. The presence of cointegration indicates a long-run relationship between the variables.

Domestic Australian investment

The main factor driving domestic investment is lagged national output (Australian GDP) (see Table F.3). As capital is a major input to production, investment increases with output.

Both inward and outward foreign investment (FDI and ADIA, respectively) are positively related to domestic investment. A one per cent increase in ADIA is estimated to increase domestic Australian investment in the next year by 0.019 per cent. The LR statistic supports the positive relationship between ADIA and domestic investment.

The age of the capital stock, the price of Australian investment, the public capital stock, the real interest rate differential and Tobin's Q (the ratio of the rate of return on capital to the cost of funds) also were tested, but eliminated from the preferred model. Tobin's Q, the price of investment and the real interest rate differential might be expected to influence investment in the short run, but the relationship estimated is a long-run relationship.

Once again, the estimated model performs well. The high adjusted R^2 indicates that the estimated model is a good fit, and the Durbin-Watson statistic indicates the absence of autocorrelation. There is statistical evidence of a clear long-run relationship between the variables.

Employment

The skill level (human capital) was the major factor explaining domestic employment — as skill levels increase, the demand for labour declines, holding all other factors constant (see Table F.4). This quality/quantity trade-off need not translate into a decrease in equilibrium employment for the economy as a whole, because other factors (for example, R&D) can increase both employment and skill levels. The positive relationship between employment and the private capital stock indicates that capital complements labour. As expected, the level of output (Australian GDP) and FDI are also factors explaining domestic employment. The demand for labour falls (with a lag of one period) as the cost of employing labour increases (real unit labour costs).

The LR statistic indicates that ADIA adds explanatory power to the estimated model. The coefficient indicates that a one per cent increase in ADIA has a 0.010 per cent increase in employment in the next year.

The only variables which were tested and excluded from the preferred model were the average number of hours worked and the cost of capital as measured by real Australian interest rates.

The estimated equation performs well. The high adjusted R^2 indicates that the estimated model is a good fit, and the Durbin-Watson statistic indicates the absence of autocorrelation. The model cointegrates, indicating evidence of a long-run relationship between the variables.

Output

The estimated production function indicates that national output is positively related to employment, the private sector capital stock and the skill level of the workforce (human capital) (see Table F.4).[12]

The presence of a strong positive relationship between output and human capital is consistent with other studies (for example, Boskin and Lau 1991, IC 1995b, Levine and Renelt 1992, and OECD 1993c). This effect is unrelated to the gain in output associated with increasing the number of people employed.

Although the LR and t tests indicate that ADIA does not add explanatory power to the output equations, ADIA is positively related to Australian output.

A time trend was included to capture the effects of disembodied technological change. It was not possible to include a measure of R&D as the ABS has published R&D data on a consistent basis only since 1975–76.

Along with the time trend, FDI, the public capital stock and the price of Australia's exports relative to the price of imports (the terms of trade) were tested to see if they explained output. None of these variables added fit to the model over the sample period.

The exclusion of the public capital stock contrasts with the finding of Otto and Voss (1994) who found it to be positive and statistically significant over the period 1966–67 to 1989–90. This difference may be explained by the fact that their measure of public capital is a *gross* measure (that is, excluding all depreciation on capital that has not been retired), whereas the measure used in this study is a *net* measure (that is, allowing for depreciation on capital that has not been retired).

Once again, the estimated model performs well. The high adjusted R^2 indicates that the estimated model is a good fit, and the Durbin-Watson statistic indicates

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12 Employment was measured as the number of employees, instead of hours worked, as the econometric results were better.

that autocorrelation is not present. The model cointegrates, indicating a long-run relationship between the variables.

F.4 Summary

This study sought to estimate econometrically the impact of ADIA on Australian activity. Given the relatively small sample size used, the econometric results presented in this appendix should be treated with a degree of caution.

All the estimated equations cointegrate, indicating stable long-run relationships between the relevant variables. All the equations did a good job of explaining variations in the variables under consideration.

The econometric results indicate that, over the period 1969–70 to 1993–94, there has been a positive relationship between ADIA and all the domestic variables considered, although only the effects on investment, employment and imports added explanatory power to the models. Although the impact of ADIA on non-rural exports was weak, the sectoral impacts not including service exports were stronger. The economy-wide results are consistent with those obtained from Australian firm-level surveys and with theoretical analysis (see Chapter 4). ADIA has either no effect, or a positive effect, on domestic activity. In this respect, the results are also similar to those of the empirical literature reviewed in Appendix E.

Table F.3: Determinants of non-rural exports, imports and investment, Australia, 1969–70 to 1993–94[a]

Dependent variable:	Non-rural exports		Imports		Investment	
	Coeffic	*t-statistic*	*Coeffic*	*t-statistic*	*Coeffic*	*t-statistic*
Explanatory variables:						
Constant	5.070	2.461	-10.906	-1.846	3.064	2.664
Time trend	0.079	10.310				
ADIA	0.006[b]	0.926 (0.525)	0.081	3.040 (18.920)	0.019[b]	2.928 (14.049)
Australian GDP			1.604	3.506	0.521[b]	5.473
Effective rate of protection			-0.407	-2.509		
FDI					0.055[b]	2.257
Own price[c]	-0.639	-6.199	-0.198	-2.234		
Real effective exchange rate			0.584	3.380		
World GDP	0.335	2.596				
World openness	0.395	3.465				
Dummy variables:						
Data adjustment			0.526	2.618		
Valuation technique					-0.159[b]	-4.161
Summary statistics:						
Number of observations	24		25		24	
Adjusted R^2	0.9885		0.9744		0.9513	
Durbin-Watson statistic	2.0657		1.8448		2.4862	
Result	No autocorrelation		No autocorrelation		No autocorrelation	
Cointegration tests:						
Phillips t-test on residuals	-4.9106		-5.2431		-7.9394	
10% critical value	-4.43		-4.70		-4.43	
Result	cointegration		cointegration		cointegration	

a Figures in parentheses denote Likelihood Ratio (LR) statistics for ADIA obtained from a Johansen estimate of the same functional form.

b Explanatory variable is lagged one period.

c Own price denotes the price corresponding to the dependent variable (for example, the price of exports for exports and the price of imports for imports).

Source: Commission estimates.

Table F.4: Determinants of output and employment, Australia, 1969–70 to 1993–94[a]

Dependent variable:	Employment		Output	
	Coeffic	*t-statistic*	*Coeffic*	*t-statistic*
Explanatory variables:				
Constant	-0.972	-1.033	4.662	3.987
ADIA	0.010[b]	2.845 (5.072)	0.002	1.071 (6.639)
Australian GDP	0.337	3.458		
Employment			0.649	6.021
FDI	0.010	1.910		
Human capital	-0.602	-6.870	0.652	3.850
Private sector capital stock	0.392	5.165	0.242	2.249
Real unit labour costs	-0.157[b]	-2.638		
Dummy variables:				
Data adjustment	0.067[b]	2.372		
Ownership level	-0.018	-1.967		
Valuation technique			0.028	2.355
Summary statistics:				
Number of observations	24		25	
Adjusted R^2	0.9961		0.9965	
Durbin-Watson statistic	1.8962		2.0590	
Result	No autocorrelation		No autocorrelation	
Cointegration tests:				
Phillips t-test on residuals	-5.0570		-4.9902	
10 % critical value	-4.70		-4.70	
Result	cointegration		cointegration	

a Figures in parentheses denote Likelihood Ratio (LR) statistics for ADIA obtained from a Johansen estimate of the same functional form.

b Explanatory variable is lagged one period.

Source: Commission estimates.

Table F.5: Determinants of Australian exports, by sector, 1976–77 to 1992–93[a]

Sector	Mining		Manufacturing		Services	
	Coeffic	*t-statistic*	*Coeffic*	*t-statistic*	*Coeffic*	*t-statistic*
Explanatory variables:						
Constant	39.392	4.713	11.515	29.950	6.042	8.666
Time trend	0.044	4.859	0.103	17.220	0.082	10.720
ADIA	0.033	2.397	0.026	2.725	0.010[b]	4.291
International visitors					0.437	10.700
Own price of exports[c]			-1.104	-13.09	-0.914	-10.92
Transport costs	-8.328	-5.025				
World GDP	0.537	3.569				
World openness	-0.505	-2.371	0.719	6.239		
Dummy variables:						
Data adjustment			0.199	3.062		
Ownership level			-0.077	-2.322		
Valuation technique	0.382	4.331				
Summary statistics:						
Number of observations	17		17		16	
Adjusted R^2	0.9844		0.9905		0.9980	
Durbin-Watson statistic	2.2298		2.4236		2.8086	
Result	No autocorrelation		No autocorrelation		No autocorrelation	
Cointegration tests:						
Phillips t-test on residuals	-4.8113		-5.7343		-5.9626	
10% critical value	-4.70		-4.70		-4.15	
Result	cointegration		cointegration		cointegration	

a The limited number of degrees of freedom prevented the use of the Johansen estimation procedure.
b Explanatory variable is lagged one period.
c Own price of exports denotes the corresponding export price for that sector (for example, the price of manufactured exports for the manufacturing sector).
Source: Commission estimates.

APPENDIX G: INTERNATIONAL APPROACHES TO INVESTMENT LIBERALISATION

Australia has been a party to a number of international cooperative initiatives aimed at liberalising investment. These have involved various multilateral, regional and bilateral approaches to removing measures affecting foreign investment. This appendix discusses these international developments and Australia's involvement in these areas, as well as those agreements between other countries that may impact on Australia's overseas investment interests. The attachment summarises the key features of the main multilateral, regional and bilateral initiatives taken to liberalise global investment.

G.1 Multilateral approaches

World Trade Organisation

The World Trade Organisation (WTO) commenced on 1 January 1995 following the Uruguay Round. It administers important multilateral agreements such as the General Agreement on Tariffs and Trade (GATT), the Agreement on Trade Related Investment Measures (TRIMS) and the General Agreement on Trade in Services (GATS). Although attempts to include investment directly into the Uruguay Round negotiations met with little success, the addition of TRIMS and GATS to the GATT/WTO represents two important new multilateral agreements that are binding on all members and have a bearing on foreign investment.

Trade Related Investment Measures

TRIMS seeks to liberalise a narrow range of investment measures that distort trade in goods. The agreement essentially reaffirmed GATT obligations on national treatment (GATT Article III) and prohibitions on quantitative restrictions (GATT Article XI). National treatment requires members to treat imports no less favourably than domestic products.

Members agreed to apply national treatment to:

- local content measures — requirements on the enterprise to purchase or use products of a domestic origin; and

- trade balancing measures — requirements that an enterprise's purchase or use of imports is limited to the volume or value of local production that it exports.

The elimination of quantitative restrictions applies to:

- trade balancing restrictions;
- foreign exchange balancing restrictions — measures that restrict imports by restricting an enterprise's access to foreign exchange to the amount of foreign exchange inflows; and
- export restrictions — measures that restrict the export or sale of products.

Members are allowed different transition periods to remove GATT-inconsistent measures (two years for developed countries, five years for developing countries or seven years for least developed countries). GATT-inconsistent measures were to be notified by members within 90 days of the WTO's commencement.[1] The Council for Trade in Goods is to review TRIMS within five years, with a view to adding provisions regarding investment and competition policies.

In its current form, the list of TRIMS does not include overall performance requirements and investment incentives. However, its scope may be extended in future to cover more widely investment policies and related measures.

General Agreement on Trade in Services (GATS)

Since investment is one of the main means by which services are traded internationally, the creation of the GATS to incorporate government policies affecting international trade in services into the system of multilateral trading rules has direct implications for investment. Effective from 1 January 1995, GATS covers all modes of supplying services internationally, namely: cross-border supply; consumer movements; commercial presence; and temporary movements of people across borders. Commercial presence refers to the right of establishment in the host market and therefore covers foreign investment in services.

GATS's coverage extends to all levels of government of both developed and developing countries, although the latter have flexibility in implementing the provisions on transparency, regional integration and progressive liberalisation.

1 Notification is through the TRIMS Committee established to monitor the agreement. As of late May 1995, five APEC economies (Indonesia, Malaysia, Mexico, the Philippines and Thailand) had notified TRIMS-inconsistent policy measures. All five economies notified local content measures for motor vehicles.

All services are included in principle, except air landing rights and services supplied in the exercise of government functions.

The agreement contains a set of general commitments applying to all members and sectors, as well as specific sectoral commitments scheduled by individual countries. The general obligations provide for most-favoured-nation (MFN) treatment, regional integration, transparency and other commitments. Countries' schedules of specific commitments address national treatment and market access obligations, subject to various qualifications or conditions. These obligations cover only sectors scheduled by members.

Market access, although not defined in the GATS, requires members to give foreign suppliers of scheduled services treatment no less favourable than the terms and conditions specified in its schedule. Six specified categories of quantitative restrictions which would restrict market access are prohibited for these sectors.

National treatment covers all restrictions that discriminate between domestic and foreign suppliers within the scheduled sectors. In other sectors, any restrictions are permitted, provided that the measures do not discriminate among foreign suppliers.

The unconditional MFN obligation establishes non-discrimination among all WTO member countries. Restrictions or exemptions applied against one member must be extended to all other members equally. However, GATS permitted certain sub-sectors in which there are no specific obligations to be exempted from MFN treatment. Except for financial services, basic telecommunications and maritime transport services, exemptions had to be lodged by 1 January 1995 and could not be broadened. For financial services, basic telecommunications and maritime transport services, negotiations which included the application of MFN continued beyond the inception of GATS in January 1995.[2] Reviews of all MFN exemptions are to take place after five years.

Central to the GATS are the schedules of specific commitments which determine the application of the agreement in practice. Adopting a positive list approach to sectors, the schedules list specific service sectors and the mode of delivery for each. Once scheduled, only those measures specified as exemptions

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[2] MFN provisions are currently suspended for basic telecommunications and maritime transport services pending the outcome of negotiations in these sectors. Negotiations for basic telecommunications are due to be completed in February 1997. Maritime negotiations have been suspended until the new round of services negotiations in 2000. Under the interim Financial Services Agreement, all members, except the United States, have extended MFN treatment to financial services.

to market access and national treatment (that is, a negative list) may be maintained. The specific commitments can be either bound or unbound. Unbound commitments provide members the freedom to maintain existing restrictions or introduce new ones in scheduled sectors. Bound commitments indicate that countries do not, and will not, impose restrictions. In addition, members have also included horizontal commitments covering laws and general policy measures applicable to all sectors. These are mostly related to restrictions of foreign investment and temporary movement of natural persons.

Due mainly to its sectoral specificity, the GATS is limited in its usefulness to liberalising services trade.[3] Moreover, the agreement contains no commitments to liberalise trade in services, especially in sectors that are not scheduled, or scheduled with unbound commitments. However, as stated in its preamble, progressive liberalisation through successive rounds of multilateral negotiations is an objective of GATS.

OECD investment instruments

The OECD's investment instruments currently come closest to a multilateral investment agreement. They are the Codes of Liberalisation of Capital Movement and Current Invisible Operations adopted in 1961, and the national treatment provisions contained in the 1976 Declaration and Decisions on International Investment and Multilateral Enterprises. The Codes deal with transactions between residents and non-residents, while the national treatment instrument is concerned with resident foreign-controlled enterprises.

Codes of Liberalisation of Capital Movements and Current Invisible Operations

The OECD Codes are 'legally binding' on all members.[4] Their objectives are to promote progressive liberalisation of members' investment regimes. The OECD recommends that the liberalisation provisions be extended to all International Monetary Fund members.

The Capital Movements Code covers the restrictions imposed on all cross-border capital operations, including inward and outward foreign investment and the right of establishment for non-resident enterprises. Transactions involved in the creation or extension of a wholly-owned enterprise, subsidiary or branch, the acquisition of full ownership of an existing enterprise, as well as participation in a new or existing enterprise, are all within its purview. The

3 See IC 1995c (Appendix G).

4 The Codes have the legal status of OECD Council decisions binding on all members.

Current Invisibles Code includes current payments and transfers in connection with business, industry, foreign trade and personal income, as well as travel and tourism, cross-border trade in transport services, financial services and films.

The Codes encourage the elimination of restrictions through liberalisation and non-discrimination obligations. The obligation to liberalise requires not only that transactions should be free from exchange control restrictions, but also that they not be frustrated by legal or administrative regulations. The non-discrimination obligation requires that restrictive measures be liberalised so as to apply to all members on an equal basis. Members belonging to 'special customs or monetary systems' are allowed to apply to one another additional liberalisation measures without having to extend them to other OECD members.

The Codes allow members to undertake liberalisation at different speeds. When members adhere to the Codes, they are permitted to lodge reservations against specific measures that they do not wish to liberalise.[5] Members can maintain restrictions on the operations concerned, provided that they are non-discriminatory among members and subject to full transparency. Peer pressure reviews are adopted to encourage members to pursue liberalisation. All members, except Luxembourg, have exercised reservations on inward direct investment, usually connected to services (see Tables G.1 and G.2).

The Codes have standstill provisions to preserve the liberalisation efforts already achieved and to promote the roll-back of restrictive measures. Limited reservations cannot be broadened and a reservation, once withdrawn, may not be relodged, unless the operations are contained on 'List B' of the Capital Movements Code (essentially short-term financial operations and non-resident acquisitions of real estate).

5 Reservations can also be lodged whenever specific obligations begin to apply to a member, or whenever new obligations are added to the Codes.

Table G.1: Investment restrictions on main sectors in OECD countries

	Industry sectors																
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*16*	*17*
Australia	LR		L	L		**C**	L	L	L		L*	L			L	**C**	L*
Austria	R	R	**C**	**C**	**C**	**C**	**C**	L	L	L	L	L*	LR	L		L	**C**
Belgium	R	R		L	**C**	**C**	L	L		**C**	L		R			**C**	
Canada	LR*	LR*	L	L	**C**	**C**	L	L	L*	L*	L*	L*		L*	L*	L*	
Denmark	R	R	L	L	**C**	**C**	L	L			L					**C**	
Finland	LR*	R	**C**	L	R	**C**	L	L	L		L					**C**	**C**
France	LR	LR	L	L	R	**C**	L	L	L	R	L*		R	R	LR	L	L
Germany	LR		L	L	**C**	**C**	LR	L*									**C**
Greece	LR	LR	**C**	**C**	**C**	**C**	**C**	L	L	**C**	L	L	R	**C**		**C**	**C**
Iceland	L	L	L	**C**		**C**	L			**C**	**C**	L	L			**C***	
Ireland	LR	LR		**C**		**C**	**C**	LR			**C**					**C**	
Italy	LR	LR	**C**	**C**	**C**	**C**	LR	L	R		L		R			**C**	**C**
Japan	LR	L	L	L		L	L	L	**C**	**C**	L					L	
Luxembourg			**C**	**C**	L	L	L									**C**	
Netherlands	LR	L	L	L	**C**	**C**	L	L			L					**C**	
New Zealand			L	L		**C**	L	L			L						
Norway	LR	LR	**C**	L	**C**	**C**	L	L			L		L			**C**	**C**

Table G.1 (continued):

	Industry sectors																
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*16*	*17*
Portugal	LR	L	L	**C**		**C**	**C**	R						L		**C**	
Spain	R	R	L	L		**C**	L	L				L				**C**	L
Sweden	L	L	L	L		**C**	L	L									**C**
Switzerland	R	L	L	**C**		**C**	L	L				L		**C**		L	
Turkey	LR	LR	**C**	**C**		**C**	L	L			L		L			**C**	**C**
United Kingdom	R	R	L	L		**C**	L	L	L		L		L			**C**	
United States	R	R*	L	L		**C***	L	L	L		L	R*				L*	

Notes:
1. Blanks in the table indicate that no restrictions apply.
2. This table covers mainly measures upon establishment that are regarded as restrictions in the sense of the Code of Liberalisation of Capital Movements and are not covered by the general authorisation procedures. The measures are categorised as follows:
   L = Limited; R = Reciprocity; **C** = Closed to foreign competition, including monopolies and concessions; and * = Measures at subnational level.
3. Industry sectors are as follows:
   1. Banking (including financial services).
   2. Insurance.
   3. Radio broadcasting and television.
   4. Post and telecommunications.
   5. Road transport.
   6. Rail transport.
   7. Air transport.
   8. Maritime transport.
   9. Mining.
   10. Oil and/or gas.
   11. Fishing and fish-processing.
   12. Real estate.
   13. Tourism.
   14. Audiovisual works (including film distribution).
   15. Publishing.
   16. Public utilities (including energy, water, gas and electricity distribution).
   17. Gaming, casino, lottos and lotteries, etc.

Source: OECD 1992b.

Table G.2: Monopolies and concessions in OECD countries

	Industry sectors							
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*
Australia	P		P	P/Pr	P/Pr			
Austria	P		Co	Co	Co	P	P	P
Belgium	P		P/Pr	P	Pr			
Canada	P/Pr*				P/Pr		P*	
Denmark	P/Co	Co	Co		Co			
Finland	P/Pr	P	P		Pr	P	P	P
France	P	Co	P		P	P	P	
Germany	P/M	P/Co	P/Co			P/M	P/M	P
Greece	P		P	P	P	P		P
Iceland	P				P			P
Ireland	P		P	M	P			
Italy	P	Co	P		P			P
Japan	P						P	
Luxembourg	P	P			P			
Netherlands	P	Pr	P/Pr		P			
New Zealand	P		P		P			
Norway	P	P/Co	P/Co	Co	P/Co		P	P
Portugal	P/Co		P	P	P			
Spain	P/Pr	Co	P/M/Co		P		M	Co
Sweden	P	P				P	P	P
Switzerland	P	M	P/M	M			P	
Turkey	P	P	P		P		P	P
United Kingdom	P/M		P		P/M*			
United States	P/Pr				P/M*		P/M*	

Notes:

1. Blanks in the table indicate that no restrictions apply.
2. More than one mark may appear where different types of monopoly exist in a sector. The symbols are: P = Public; Pr = Private; M = Mixed Private/Public; Co = Concession; * Monopolies or concessions at the subnational level.
3. Industry sectors are as follows:
   1. Post and telecommunications (including telephone service and satellite system communications).
   2. Broadcasting (radio and television) and publishing.
   3. Land transport (including railways).
   4. Air transport.
   5. Public utilities (including energy, water, gas and electricity distribution).
   6. Employment services.
   7. Trade and distribution of alcoholic beverages, tobacco and salt.
   8. Gaming and lottos, etc.

Source: OECD 1992b.

Members may withdraw liberalisation measures through safeguard provisions provided by a derogation procedure. Liberalisation measures can be suspended for up to 18 months if it can be demonstrated that they are causing serious economic and financial disturbance, or a serious deterioration in the balance of payments. However, safeguard provisions must not be discriminatory.

Members must notify the Committee on Capital Movements and Invisible Operation (CMIT) of liberalisation measures, and any other measures covered by the Code, including restrictions imposed on foreign direct investment, and the reasons for such actions.

National treatment for established foreign-controlled enterprises

The national treatment instrument is a non-binding agreement among OECD members to eliminate discriminatory practices against foreign-controlled enterprises *once established* in the domestic market. With some exceptions, members have undertaken to provide foreign-controlled enterprises treatment no less favourable than that accorded to domestic enterprises in like situations.[6] Since 1991, differences in national treatment have been allowed in certain sectors, such as finance and insurance where institutional factors hinder identical treatment, provided that competitive opportunities of foreign-controlled enterprises are not restricted.

The instrument aims to produce policy commitments to accord national treatment and remove non-conforming measures by means of encouragement, notification, periodic examinations and peer review pressure. Even though it is not binding, the instrument represents a substantive political undertaking backed by procedural arrangements that are themselves legally binding. Since 1991, all non-conforming national treatment measures of all levels of government must be reported to the Committee on International Investment and Multinational Enterprises (CIME). The CIME, like CMIT, conducts country-by-country examinations (rather than by measure), thereby strengthening peer pressure to reform.

The principal measures covered by the instrument fall into five categories: investment by established foreign-controlled enterprises; official aids and subsidies; tax obligations; government purchasing and public contracts; and access to local bank credit and capital markets. Within these categories, members have nominated measures as ‘exceptions’ to national treatment or ‘transparency items’. ‘Exceptions’ are measures that violate the national treatment principle by treating foreign-controlled enterprises less favourably

6 The 1976 Declaration also included an instrument on investment incentives and disincentives aimed at encouraging transparency, consultation and review of such measures.

than domestic enterprises in like situations. 'Transparency items' are discriminatory measures that are applied for reasons of public order or essential security interests. Monopolies, whether public, private or semi-public, are not defined as exceptions to national treatment, but must be reported for transparency reasons.

The instrument has a number of drawbacks. Commitment to accord national treatment is limited in activities restricted for reasons of public order and essential security interests. There are also no standstill provisions prohibiting the introduction of new non-conforming measures. In addition, concern has been expressed over the use of reciprocity measures by some OECD members to accord national treatment to other economies in return for similar treatment.[7] Such arrangements violate national treatment if they result in less favourable treatment for foreign enterprises. They also violate non-discrimination if they discriminate among foreign countries. As exceptions to national treatment, reciprocity arrangements are discouraged and must be notified.

Multilateral agreement on investment

Following a review of existing investment instruments, OECD members agreed in May 1995 to commence negotiation on a broader multilateral agreement on investment (MAI). The discussions aim to achieve a stronger, more uniform multilateral investment framework to address various inadequacies of the current instruments. The negotiation is to be concluded by May 1997.

The new agreement will replace existing instruments and incorporate key features of a comprehensive multilateral framework for liberalising investment regimes. The agreement is intended to be binding and open to non-member countries. It also includes standstill, roll-back, national treatment and MFN commitments. In addition to in-built dispute settlement and enforcement procedures, areas such as performance requirements, movement of key personnel, monopolies and concessions, privatisation, corporate practices and investment incentives are being negotiated.

These developments largely reflect a dissatisfaction with existing OECD instruments — substantial exemptions are still allowed and no formal mechanism for enforcement and dispute settlement exists. The non-binding nature of the national treatment instrument and the failure to introduce effective standstill and roll back commitments to date have led members to use the lesser requirement of applying equal treatment progressively to foreign investors. Moreover, while the OECD codes apply non-discrimination between economies as the rule, increasing use of bilateral reciprocity arrangements have been

7 Especially in banking and financial services.

resorted to in extending the provisions beyond OECD members (as encouraged by the agreement). These detract from national treatment and non-discrimination.

A major drawback of any OECD-based investment agreement is that only the world's leading industrial countries will be involved in its negotiations. The intention of those countries that initiated the MAI negotiations was that the agreement, having been reached within the OECD, would then be available for all countries to join. However, many developing countries have been critical of their exclusion from its negotiation.

The World Bank guidelines

After extensive consultation and reviews of existing investment agreements, the World Bank recommended a set of guidelines on the treatment of foreign direct investment in 1992. The guidelines are non-binding codes of conduct designed only to form a basis for countries to create an open and liberal investment regime. They provide for the equal treatment of investors in similar circumstances, free competition, rights of establishment, expropriation and dispute settlement.

Governments are to facilitate the free admission and establishment of foreign investment. Regulations and unnecessary conditions on foreign direct investment are not to be imposed, and they can be exempted only on grounds of national security, or the need to meet economic development objectives or national interest. Exemptions should be applied equally to foreign countries.

The guidelines recognise that performance requirements on foreign investment are counter-productive. Governments are to regularly publish a handbook on foreign investment legislation, regulations and procedure.

According to the guidelines, foreigners must receive the same favourable treatment as nationals, especially in specified areas such as property rights, granting of permits, import and export licences and employment rights. In all other areas, investment legislation and regulations should not discriminate against foreign investors.

Expropriation of foreign investment is allowed only through legal procedures to 'serve a public purpose' and must not discriminate. Prompt compensation should be based on the assets' fair market value at the time of expropriation.

The mechanisms for dispute settlement allow for negotiations among the parties and arbitration through national courts and other agreed mechanisms. The International Centre for Settlement of Investment Disputes (ICSID), which is part of the World Bank family of organisations, is recommended for international conciliation and arbitration.

G.2 Regional approaches

APEC investment principles

In recognition of the growing importance of foreign direct investment and the need to develop an international investment agreement aimed at supplementing unilateral reforms within the Asia-Pacific region, APEC members endorsed the APEC Investment Principles in 1994. Commitments to achieve free and open trade and investment in the region (by 2010 or 2020) were also stated by APEC leaders in the Bogor Declaration. In 1995, the members further agreed on the Osaka Action Agenda for the implementation of the Bogor Declaration. The Agenda contains unilateral and collective actions on investment arrangements within the region.

The APEC investment principles are non-binding in nature and reflect aspirations to achieve investment liberalisation, rather than legal requirements to carry out immediate policy changes. Reflecting the diversity in investment regimes and the stage of economic development within the region, the non-binding nature was adopted to facilitate agreement on the initiative and to provide a platform for future dialogue on investment issues. The principles also created an important educative process for APEC members not familiar with investment liberalisation.

The principles contains key provisions on national treatment, non-discrimination and transparency. Under the national treatment provision, members will accord to foreign investors treatment no less favourable than domestic investors, subject to exceptions provided for in domestic laws, regulations and policies. These exceptions, however, are not subject to standstill and roll-back commitments. Although not explicitly covered in the principles, rights of establishment are contained in national treatment and non-discrimination provisions.

Consistent with the goal of ‘open regionalism’, the principles call for non-discrimination between members and non-members alike, without prejudice of existing international obligations (regional trading arrangements or bilateral agreements). Members will extend to foreign investors from all countries treatment no less favourable than that accorded to foreign investors from a particular country.

Members agreed to make available and transparent all laws, regulations, administrative guidelines and policies pertaining to investment. However, members were not required to list activities excluded from national treatment provisions.

Other relevant principles cover performance requirements, investment incentives, expropriation, repatriation, settlement of disputes, entry and sojourn of personnel, avoidance of double taxation, investor behaviour and removal of barriers to capital exports. Again, the application of these principles is not binding and in practice, members have ample room to decide the extent of investment liberalisation.

With performance requirements, members were only asked to 'minimise' their use. Virtually no limitations were imposed on the use of investment incentives to attract foreign investment — members only agree not to relax health, safety and environmental regulations to attract foreign investment. Members agreed to 'minimise' barriers to investment outflow, and endeavour to 'avoid' double taxation. Temporary entry of key personnel related to foreign investment is permitted, subject to domestic laws and regulations.

Expropriation of foreign investment is to be only for a 'public purpose' and on a non-discriminatory basis in accordance with each economy's legislation and principles of international law. Compensation is to be paid promptly. Members are to liberalise 'towards the goal' of allowing free and prompt transfer of funds related to foreign investment.

Reflecting the concern of APEC developing countries, a code of conduct for foreign investors was included in the principles. Foreign investors are expected to abide by the host economy's laws and policies in the same way as domestic investors.

While members are not strictly bound by the principles and, hence, legally no protection for investors is provided, the recognition that disputes may arise led to the inclusion of a provision on dispute settlement. The principles state that disputes between members are to be settled by consultation and negotiation among APEC members. Failing this, matters should proceed to arbitration in accordance with members' international commitments, or to some agreed arbitration procedures acceptable to both parties.

In relation to the APEC Investment Principles, the Osaka Action Agenda reaffirmed the Bogor commitment to the objectives of investment liberalisation by progressively providing MFN and national treatment, as well as ensuring transparency. Another agreed objective is the facilitation of investment activities through technical assistance and cooperation. These objectives are to be achieved by members' unilateral as well as collective actions.

Unilateral actions include the progressive reduction and elimination of exceptions and restrictions through the use of existing multilateral investment agreements (including APEC Investment Principles). The agenda confers recognition for the expansion of APEC’s network of bilateral investment arrangements.

Collective actions cover measures to: improve the transparency of APEC investment regimes; promote a business consultative mechanism; identify technical cooperation and training needs; and undertake research and evaluation of APEC investment issues. A dialogue process with the OECD and other international fora on investment issues is also established.

North American Free Trade Agreement

The North American Free Trade Agreement (NAFTA) between Canada, the United States and Mexico came into force on 1 January 1994. Chapter 11 of NAFTA contains the main provisions on the treatment of investment within the region.[8]

The Chapter contains provisions on national treatment, MFN, minimum standards of treatment, performance requirements and on an investor-state dispute settlement mechanism. The national treatment provisions stipulate that each member must accord to investors and investments of other NAFTA members treatment no less favourable than that accorded to its own investors. Members are also prohibited from imposing a minimum level of local equity.

The MFN provisions require each member to accord to investors and investments of other NAFTA members treatment no less favourable than that accorded to investors and investments of non-members. However, these MFN provisions allow foreign investors based in North America the better treatment among all foreign investors in cases where a member has a reservation against national treatment. This permits discrimination between NAFTA countries and non-members who do not provide for reciprocal arrangements.

With reservations, non-NAFTA investors who are established in one NAFTA member country wanting to expand operations in another NAFTA member are entitled to NAFTA rights (Article 1113).

NAFTA went beyond the TRIMS agreement of the WTO in imposing limits on the use of performance requirements on foreign investment from members and

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[8] Other chapters and provisions related to investment are the provisions on services and financial services (Chapters 12 and 14), intellectual property rights (Chapter 17), rules of origin and provisions on duty drawback and deferral.

non-members. These include: export requirements; domestic content requirements; import requirements; trade balancing requirements; the linking of domestic sales to export levels or foreign exchange earnings; technology transfer requirements; and the linking of investment incentives (such as subsidies and tax advantages) to the above performance requirements.

Protection against the expropriation of investments and the repatriation of income and capital are also provided for by NAFTA. In addition, the agreement encourages dispute settlements between the investor and the signatory governments through consultation and negotiation and, failing this, through international arbitration under the rules of the World Bank's ICSID and the United Nations Commission on International Trade Law (UNCITRAL).[9] With international arbitration, an arbitration panel is also established with power to order measures to protect the disputing investor.[10]

A negative list of reservations annexed to the agreement excludes particular industries from the main provisions of NAFTA. The most important industries exempted include: the cultural industries in Canada; the maritime industry in the United States; and the energy industry in Mexico. In addition, the United States' investment review procedures are exempted under NAFTA's national security exclusions. Nevertheless, after the enactment of NAFTA, Mexico liberalised its investment restrictions and extended the liberalisation to other countries on a MFN basis.

The ASEAN Agreement on the Promotion and Protection of Investment (APPI)

The APPI is binding among ASEAN countries. The agreement accords 'fair and equitable treatment' only to member suppliers of services and does not cover national treatment or MFN. Nevertheless, members are obliged not to expropriate foreign investments, nor restrict the repatriation of income.

A dispute settlement mechanism exists within the APPI. If disputes are not settled within six months, the ICSID, the UNCITRAL or any other regional dispute forum can be used.

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9 Although Canada is not a signatory to the ICSID Convention, it does provide for the use of arbitration rules of the ICSID and UNCITRAL in its bilateral investment agreements and NAFTA.

10 Chapter 20 provides procedures for settling disputes between states.

G.3 Bilateral investment mechanisms

Apart from the Closer Economic Relations (CER) Protocol on Trade in Services with New Zealand, Australia has entered numerous recent treaties on investment with other countries, most of which are transitional and/or developing countries.

CER Protocol on Trade in Services

No formal investment agreements exists between Australia and New Zealand. The Australia-New Zealand CER Trade Agreement, established in 1983, focuses on measures affecting trade in goods rather than investment flows. Following a review of the CER in 1988, the Protocol on Trade in Services, which came into force on 1 January 1989, covers foreign direct investment only to the extent that it is related to trade in services. The agreement provides for the application of the protocol to be subject to the foreign investment policies of Australia and New Zealand.

The protocol contains provisions dealing with market access, national treatment, MFN status, commercial presence and transparency with respect to trade in services. Each member is required to provide to each other access rights to its market no less favourable than those allowed to its own investors and their services. National treatment provides for no less favourable treatment to persons and services of the other member.[11] Service providers have the right to select their preferred form of commercial presence, subject to the laws and regulations of the member. Transparency arrangements allow for the prompt publication of measures affecting trade in services and the opportunity for comment by interested parties.

The protocol also adopted standstill and roll back provisions. Members are not permitted to introduce discriminatory and restrictive measures, including those affecting the establishment and commercial presence of the service providers of the other member. Exemptions to the protocol are to be regularly reviewed with a view to liberalisation of trade in services. Members also undertake not to introduce new measures on export subsidies, export incentives and other government assistance measures that directly distort trade in services between the members.

Exemptions to the protocol are inscribed in a negative list arrangement that does not have a specific elimination date. Nevertheless, the protocol extends MFN

[11] Differences in treatment are allowed to the extent that they are no greater than necessary for prudential, fiduciary, health and safety or consumer protection reasons, and are equivalent in effect to the treatment accorded by the member to its residents for such reasons.

status to excluded sectors and no new exemptions could be added after 31 March 1989. A joint review of the list of exemptions was completed in 1995.

Other bilateral investment treaties

Bilateral investment treaties aim to provide security to investors in foreign countries. Australia has entered into a number of bilateral investment agreements with transitional or developing countries. In general, the treaties appear to follow a similar format and adopt the same key features (see Table G.3). This reflects a relatively uniform approach to negotiating bilateral investment agreements. The key features include:

- promotion and protection of investments — the parties agree to: admit investments subject to domestic laws and investment policies ‘applicable from time to time’; ensure ‘fair and equitable treatment’; and, also subject to domestic laws, provide protection and security to investments;
- MFN provision — MFN treatment is provided so long as a party is not obliged to extend to the other party any treatment resulting from regional arrangements or a double taxation agreement with a third country;
- entry and sojourn of personnel — each party, subject to its laws and policies, agrees to permit entry and sojourn of personnel;
- expropriation — expropriation and nationalisation are made only for a ‘public purpose’ and are non-discriminatory with prompt, adequate and effective compensation on a market value basis;
- compensation — in cases of losses due to war, revolution or similar events, compensation is to be provided with no less favourable treatment than that provided to investors from any third country;
- transfers — each party undertakes to permit free transfers of funds in a freely convertible currency;
- dispute settlements — consultations and negotiations, and agreed international arbitration tribunals, are mechanisms for dispute settlements; and
- transparency — each party undertakes to make investment laws public and readily accessible.

These treaties tend to be narrowly focused and fall well short of achieving the broader investment liberalisation aimed for under multilateral and regional investment agreements. The national treatment obligation is absent from these bilateral treaties. The protection of investment granted by these treaties is subject to the domestic laws and policies of the host country. In addition, there are no provisions covering the use of performance requirements and investment incentives.

Table G.3: Features of recent bilateral investment agreements between Australia and foreign countries

Bilateral partner and date of entry into force	*Promotion and protection of investments*	*MFN provisions*	*Entry and sojourn of personnel*	*Expropriation*	*Compensation*	*Transfers of funds and earnings*	*Transparency*	*Dispute settlement*
Peru[a]	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Argentina[a]	Yes	Yes	Yes	Yes	Yes	Yes	None	Yes
Philippines (1995)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Laos (1995)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Czech Republic (1994)	Yes	Yes	Yes	Yes	Yes	Yes	None	Yes
Romania (1994)	Yes	Yes	Yes	Yes	Yes	Yes	None	Yes
Hong Kong (1993)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indonesia (1993)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Poland (1992)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Hungary (1992)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Papua New Guinea (1991)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Vietnam (1991)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
China (1988)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

a These agreements have not entered into force.

Source: Department of Foreign Affairs and Trade (various years).

Attachment

This attachment provides details, in table form, of the key features of various multilateral and regional approaches to investment liberalisation. The agreements covered are: TRIMS; GATS; OECD codes; OECD's national treatment instrument; MAI; World Bank's guidelines; APEC investment principles; NAFTA; APPI; and the CER protocol on trade in services.

Key features of multilateral and regional approaches to investment liberalisation

	TRIMS	*GATS*	*OECD Codes*	*OECD Instrument*	*OECD's proposed MAI*
Coverage	Five types of investment measures related to trade in goods. Covers all government levels.	Investment is covered under 'commercial presence'. Covers all government levels.	Transactions between residents and non-residents. Covers all levels of government.	Treatment of foreign firms once established in domestic market by all government levels.	Extends existing OECD investment instruments. Open to outside members.
Type of commitment	Binding.	Binding.	'Legally' binding.	Non-binding.	Binding and provisions for enforcement.
Transparency	Notification of TRIMS and GATT transparency provisions reaffirmed.	Publication and notification of all measures.	Notification of measures and country reviews by CMIT.	Notification of measures and country reviews by the CIME.	Intends to adopt broader obligations on transparency.
National treatment	No discrimination against foreigners, except for frontier barriers that were not proscribed (ie tariffs).	Covers only scheduled sectors subject to bound commitments not to violate national treatment.	Obligation to liberalise subject to public order and essential security interests.	Exists as core commitment of the agreement. Exceptions are only for public order and security interests.	Aims for broader national treatment obligations with derogations subject to negotiation.
Most-favoured-nation (MFN) treatment	Exists for WTO members.	Exists for WTO members, but with sectoral exemptions.	Exists for OECD members. Extending liberalisation to all IMF members recommended.	Applies when adding or removing measures contrary to national treatment.	Extends MFN treatment to all signatories.
Market access or right of establishment	Prohibits quantitative restrictions on imports and exports.	Prohibits six types of quantitative restrictions within scheduled sectors.	Covered subject to 'reservations', and safeguard provisions.	Monopolies must be reported for transparency reasons.	Under negotiation.
Performance requirements	Prohibits only certain types of requirements.	None.	None.	None.	To be subject to national treatment.

Key features (continued)

	TRIMS	*GATS*	*OECD Codes*	*OECD Instrument*	*OECD's proposed MAI*
Investment incentives	Covered only those incentives relating to prohibited performance requirements.	None.	None.	None.	To be subject to national treatment.
Commitments to liberalisation	To be reviewed within five years. Scope for wider power.	Limited standstill commitment. Restrictions can still be maintained or introduced in unscheduled or scheduled sectors with unbound commitments.	Standstill and roll-back provisions on reservations. Peer pressure reviews encourage liberalisation with safeguard provisions.	Commitment to accord national treatment is limited, subject to public order and essential security interests. Reciprocity is a major concern among OECD members.	It is intended to incorporate standstill and roll-back provisions.
Competition policy	May be covered in the future when review of TRIMS take place.	Monopoly suppliers are to abide by the MFN principle.	None.	None.	Likely to cover monopolies, privatisation and state enterprises.
Expropriation	None.	None.	None.	None.	Under negotiation.
Repatriation	None.	None.	Exists for members.	None.	Under negotiation.
Avoidance of double taxation	None.	None.	None.	None.	None.
Entry and sojourn of personnel	None.	Permitted for supplying a service.	None.	None.	Under negotiation.
Dispute settlement	WTO agreement on dispute settlement.	WTO agreement on dispute settlement.	None.	None.	Under negotiation.

Key features (continued)

	APEC	*World Bank Guidelines*	*Chapter 11, NAFTA*	*ASEAN Agreement on the Promotion and Protection of Investment*	*CER Protocol on Services*
Coverage	Investment.	Investment.	Investment.	Investment and all levels of government.	Trade in services subject to foreign investment policies.
Type of commitment	Non-binding.	Non-binding.	Binding.	Non-binding.	Binding.
Transparency	Members endeavour to achieve transparency.	Encourages publication and updating of information on FDI.	Publication and notification of measures are required.	None.	Members undertake to make public all laws and regulations on FDI.
National treatment	Applies in relation to establishment, operation and protection of investments, subject to exceptions.	States should accord foreign investors fair and equitable treatment as favourable as that accorded to national investors in similar circumstances.	Exists for NAFTA members at all levels of government with qualifications. Minimum local equity is prohibited.	Members are to accord fair and equitable treatment to foreign investors.	Exists. Difference in national treatment is allowed for prudential or consumer protection reasons.
Most-favoured-nation (MFN) treatment	Extends to members and non-members in relation to establishment, expansion and operation of investments.	A state should not discriminate among foreign investors.	Exists for NAFTA members. Members can receive better treatment than non-members.	Foreign investors shall receive treatment no less favourable than investors of the most favoured nation.	Exists for members.
Market access or right of establishment	Covered under national treatment and MFN obligation.	Covered under national treatment obligation.	None.	None.	Suppliers can select the form of commercial presence.

Key features (continued)

	APEC	*World Bank Guidelines*	*Chapter 11, NAFTA*	*ASEAN Agreement on the Promotion and Protection of Investment*	*CER Protocol on Services*
Performance requirements	Members only undertake to 'minimise' the use of performance requirements.	Recognises that performance requirements are often counter-productive.	Prohibits performance requirements based on exports, domestic content, trade balancing and technology transfer.	None.	Export subsidies and incentives and other measures are not to be introduced or expanded.
Investment incentives	Members will not relax health, safety and environmental regulations as an incentive to encourage investment.	Recommends against competition among economies in providing foreign investors with tax exemptions or other fiscal measures.	It is inappropriate to relax domestic health, safety and environmental measures solely to encourage foreign investment.	None.	Members agree to review services listed in the annex with a view to liberalising trade in services.
Commitments to liberalisation	Exceptions are not subject to standstill and roll-back provisions.	None.	None.	None.	Review of exemptions. No new measures can be added after 1989.
Competition policy	None.	None.	None.	None.	Monopolies are not to subsidise services in competition with other member's suppliers.

Key features (continued)

	APEC	*World Bank Guidelines*	*Chapter 11, NAFTA*	*ASEAN Agreement on the Promotion and Protection of Investment*	*CER Protocol on Services*
Expropriation	Is only for a public purpose and should be non-discriminatory, in accordance with domestic and international law, and with compensation.	Is only for a public purpose and should be non-discriminatory, in accordance with legal procedures and with compensation.	Is only for a public purpose and should be non-discriminatory in due process of law with compensation.	Is only for public use and non-discriminatory, and with compensation.	None.
Repatriation	Members will further liberalise towards the goal of the free and prompt transfer of funds in freely convertible currency.	Proposes that transfers related to foreign investment should be freely allowed by host governments.	Members must permit the free and undelayed transfer of funds.	Each member shall permit the prompt repatriation of funds in a freely available currency.	None.
Avoidance of double taxation	Members endeavour to avoid double taxation.	None.	None.	Covered under double taxation treaties and domestic laws.	None.
Entry and sojourn of personnel	Allowed subject to domestic laws.	Permission is recommended.	None.	None.	None.
Dispute settlement	Through consultations and negotiations, and international arbitration or agreed procedures.	Negotiations between investor and host state, and ICSID.	Provides for the resolution of investor-to-state as well as state-to-state disputes.	ICSID or other agreed international arbitration.	Consultation.

Sources: PECC 1995, BIE 1995i, IC 1995c, OECD 1995c and OECD 1993a.

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