C Foreign direct investment

There is a range of barriers to direct investment between Australia and New Zealand (box C.1). The main types of barriers are:

- restrictions on inward investment (including investment screening processes and limits on foreign ownership)
- discriminatory taxation arrangements that may discourage outward foreign investment (the main example is allowing imputation credits for domestic but not foreign dividends)
- non-discriminatory market access issues (for example, anti-competitive arrangements that deter market entry by both domestic and foreign firms).

This paper focuses on the first category of barriers and considers possible reforms to the Australian and New Zealand FDI regimes that would promote trans-Tasman and broader integration.

Box C.1 **Foreign direct investment**

Foreign direct investment is made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is located in an economy other than that of the direct investor.

The objective of FDI is to establish a long-term strategic relationship with the direct investment enterprise that ensures a significant degree of influence by the direct investor in its management. Generally, a 'lasting interest' is evidenced when the direct investor owns at least 10 percent of the voting power of the direct investment enterprise.

FDI differs from portfolio investment in that portfolio investors do not generally expect to directly influence the management of the enterprise.

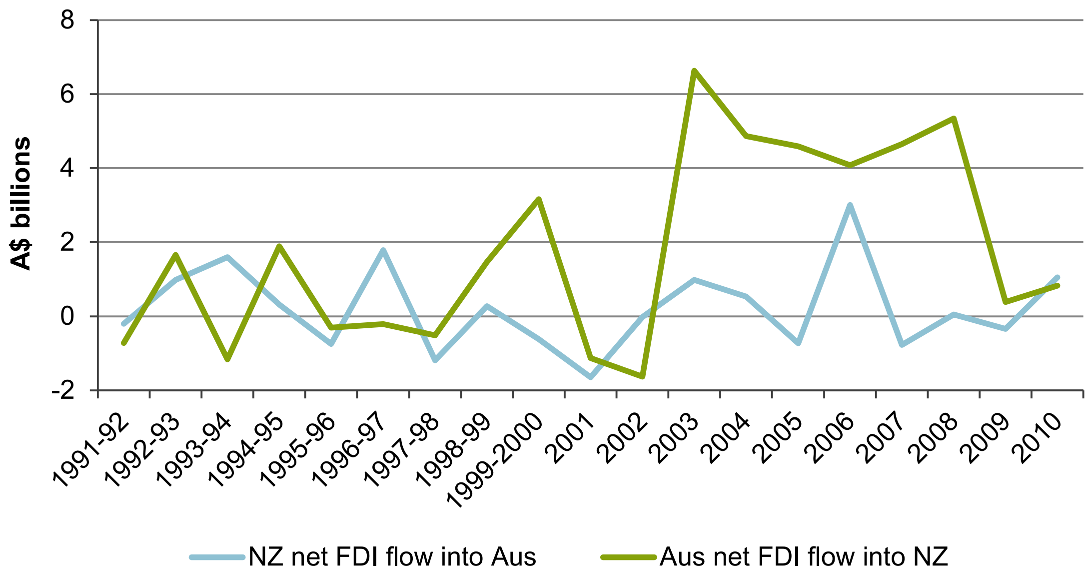
Source: OECD (2008).

C.1 Trans-Tasman FDI

There is a strong bilateral investment relationship between Australia and New Zealand. Australia is the largest foreign investor in New Zealand. According to the ABS, Australians held investments worth around A$74 billion in New Zealand in 2010. Over half of this (A$39 billion) was classified as foreign direct investment (FDI) (ABS 2012). In the other direction, New Zealand is Australia's ninth largest source of foreign investment. In 2010, New Zealanders held investments worth around NZ$34 billion in Australia, with just under one fifth (NZ$6.5 billion) being FDI (Statistics NZ 2011).

Between 1991-92 and 2010, the flow of New Zealand FDI into Australia alternated between periods of net inflows and net outflows (figure C.1). The total stock of New Zealand FDI in Australia fluctuated between approximately A$6 billion and A$11 billion (figure C.2). Australian FDI in New Zealand alternated between net inflows and outflows from 1991-92 to 2002. From 2003 to 2010, strong inflows of Australian investment contributed to an increase in the stock of Australian FDI in New Zealand from around A$25 billion to A$39 billion (figures C.1 and C.2).

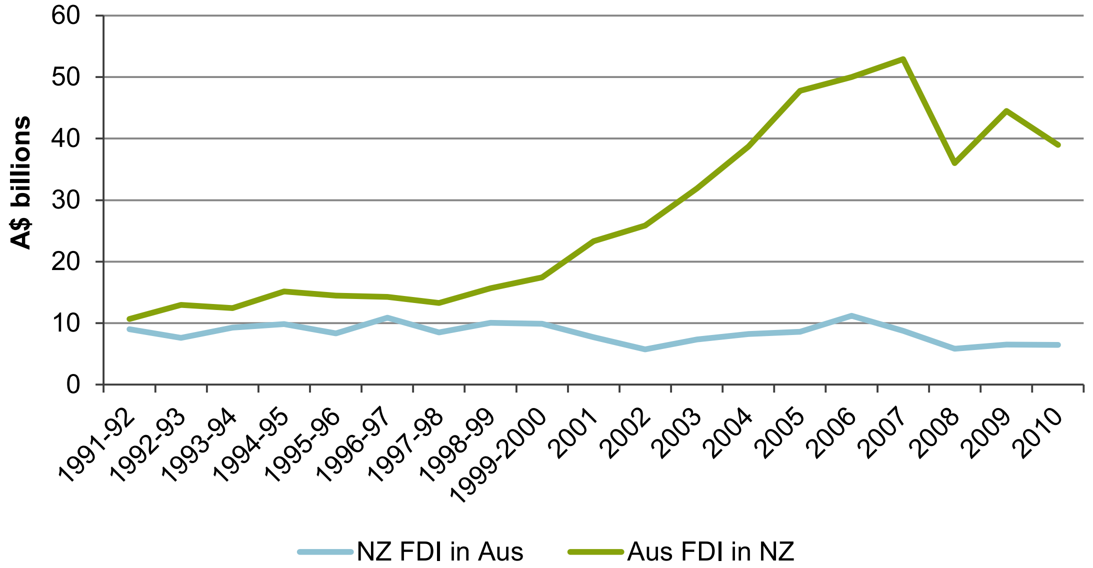
Figure C.1 **Trans-Tasman net annual flows of FDI, 1991-2010, 2010 prices[a]**



[a] Net annual flows of FDI are equal to total inflows minus total outflows. Data from 1991-92 to 1999-2000 are for financial years ending 30 June. Data from 2001 onwards are for calendar years ending 31 December.

Sources: ABS (2001; 2012).

Figure C.2 **Trans-Tasman stocks of FDI, 1991-2010, 2010 prices[a,b]**

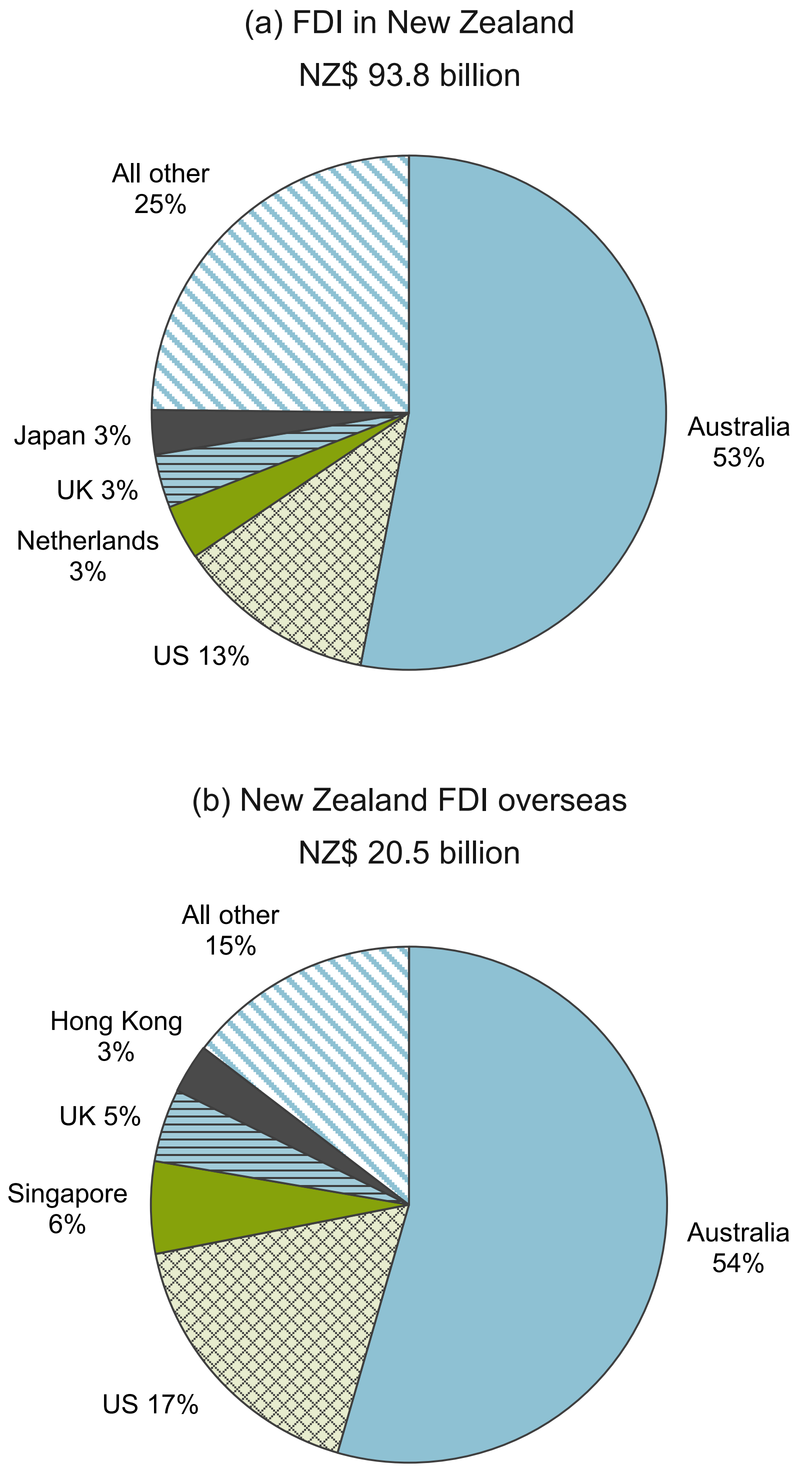


[a] The 'stock' of FDI is a measure of all such investment at a point in time. Data from 1991-92 to 1999-2000 is for financial years ending 30 June. Data from 2001 onwards is for calendar years ending 31 December. [b] 'Stock' reflects the accumulated effects of all previous FDI flows as well as changes in a number of variables including asset prices and exchange rates.

Sources: ABS (2001; 2012).

In 2010, Australia accounted for around 53 percent of all FDI in the New Zealand economy (about NZ$49.7 billion from a total of NZ$93.8 billion) (figure C.3a). This represented around 11 percent of Australia's total overseas holdings of FDI (figure C.4b). In the same year, New Zealand accounted for around 1.4 percent of all FDI in Australia (about A$6.5 billion from a total of A$473.7 billion) (figure C.4a). This represented around 54 percent of New Zealand's total overseas holdings of FDI (figure C.3b).

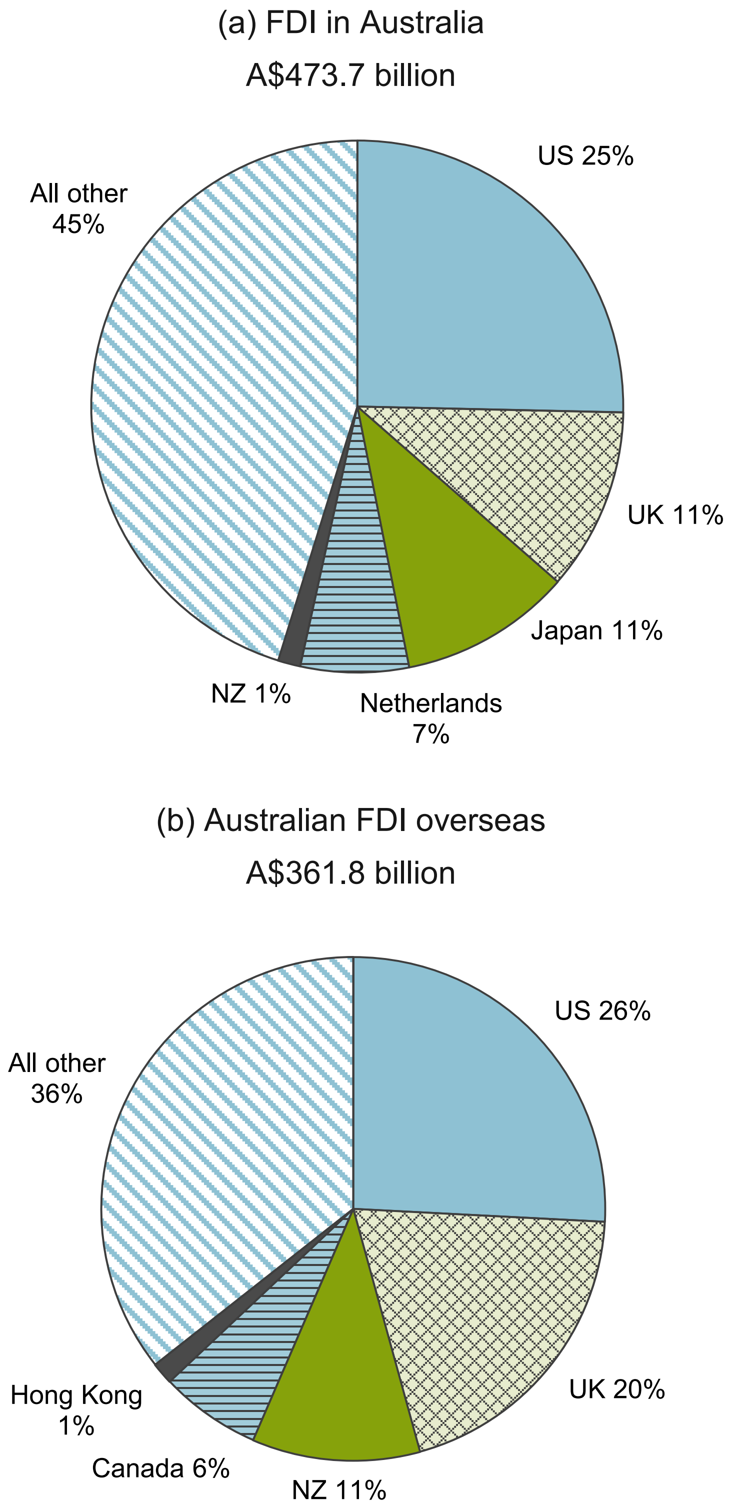
Figure C.3 **New Zealand stock of FDI, by country, 2010[a]**



[a] Data are as at 31 March 2010.

Source: Statistics NZ (2012).

Figure C.4 **Australian stock of FDI, by country, 2010[a]**



a Data are as at 31 December 2010.

Source: ABS (2012).

C.2 Current restrictions on FDI

While Australia and New Zealand acknowledge the positive contribution that foreign investment makes to the wellbeing of their citizens, both countries continue to place restrictions on such investment (FIRB 2012; NZ Treasury 2012). The CER Investment Protocol (Protocol) signed by Australia and New Zealand in 2011, but not yet enacted, reduces but does not eliminate restrictions on trans-Tasman investment flows. Tables C.1 and C.2 summarise the main restrictions and how they will be affected by the Protocol.

The Protocol aims to strengthen the economic relationship between Australia and New Zealand, reduce barriers to trans-Tasman investment flows and ensure the protection and security of investment within each country's territory. To achieve these goals, the Protocol will raise the screening thresholds that currently apply to each other's investors (except for a range of 'sensitive' sectors) and will establish a legally enforceable investment framework.

- Australia will extend to New Zealand investors the same screening thresholds it currently offers to US investors under the Australia United States Free Trade Agreement (AUSFTA) (an increase from A$231 million to A$1004 million, indexed each year). As under the AUSFTA, the higher threshold will not apply to investment in 'sensitive' sectors, including finance, media, telecommunications, transport, encryption services and uranium extraction.
- New Zealand will increase its threshold for Australian investors from NZ$100 million to NZ$477 million (indexed each year). The higher threshold will not apply to investment in sensitive land, farm land or fishing rights.
- Both countries will grant each other a set of investment rights (including a right to national treatment, protection from expropriation and enhanced transparency requirements). These rights are similar to the ones Australia has extended to US investors under the AUSFTA and New Zealand has extended to Chinese investors under the NZ–China FTA.[1]
- The Protocol includes a 'ratchet mechanism' that ensures any future unilateral liberalisation by either country will automatically be bound by the agreement and cannot be rolled back, and a most favoured nation (MFN) commitment that ensures that each country extends to the other the benefit of any additional liberalisation undertaken as a result of future agreements with other countries.

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1 The Protocol does not contain an enforcement or dispute settlement mechanism. This is similar to the arrangements for investment rights granted under AUSFTA but differs from the approach New Zealand agreed to under the NZ-China FTA (which does contain an enforcement mechanism).

- The Protocol states that the MFN clause shall not be used to prevent the New Zealand Government from according more favourable treatment to Māori (including in fulfilment of its obligations under the Treaty of Waitangi) except where the treatment is used as a means of arbitrary or unjustified discrimination against an Australian investor or as a disguised restriction on investment.

The Protocol also requires both countries to refrain from using various types of restrictions for investments from any country (for example, minimum domestic content rules are not permitted in most circumstances).

Australia and New Zealand have also made various undertakings to eliminate investment restrictions under the OECD Code of Liberalisation of Capital Movements. Each country has lodged reservations under this code in relation to the restrictions listed in tables C.1 and C.2.

Table C.1 **Australian foreign investment restrictions**

Type	*Description*	*Trans-Tasman modifications*
Screening	Test of whether proposals are contrary to the national interest are applied to foreigners acquiring an interest of 15% or more in a business or corporation valued above A$244 million.	Threshold will be A$1062 million for New Zealand (and US) investors if a prescribed sensitive sector is not involved.[a,b]
	Additional screening applies to foreign investment proposals in 'sensitive' sectors, including for:	
	• non-residential commercial real estate valued above A$53 million	Threshold will be A$1062 million for New Zealand (and US) investors.[b]
	• residential real estate (some exemptions apply)	An exemption applies to New Zealand citizens.
	• purchases of 5% or more of a firm in the media sector	None
	• new entrants or existing carriers in the telecommunications sector	None
	• new entrants or existing banks in the finance sector (the investment must be consistent with the *Banking Act 1959* (Cwlth), the *Financial Sector (Shareholdings) Act 1998* (Cwlth), banking policy, and Australian prudential requirements)	None
	• domestic and international civil aviation	None
	• ships registered in Australia	None
	• Australian airports.	None
	National interest test is also applied to all direct investments by foreign governments and their related entities.	None

(Continued next page)

Table C.1 (continued)

Type	*Description*	*Trans-Tasman modifications*
Foreign equity limits	Total foreign investment in Australian international airlines is limited to 49 percent. Additionally, for Qantas, a single foreign investor is limited to 25 percent ownership and aggregate ownership by foreign airlines is limited to 35 percent. A number of criteria must be satisfied, relating to the nationality of Board members and operational location of the enterprise.	None
	Total foreign investment in Telstra is limited to 35% (5% for individual foreign investors). A number of criteria must be satisfied, relating to the nationality of Board members and operational location of the enterprise.	None
	Total foreign investment in Australian airports offered for sale by Commonwealth is limited to 49% (additional limits on cross ownership with airlines and other airports).	None
	Ships registered in Australia must be majority Australian-owned.	None

[a] Australian sensitive sectors include finance, media, telecommunications, transport, encryption services and uranium extraction. [b] The amount is for 2012 and is indexed annually by the GDP implicit price deflator.

Sources: Australian Government Treasurer (2012); DFAT (2012); FIRB (2012).

Table C.2 **New Zealand foreign investment restrictions**

Type	*Description*	*Trans-Tasman modifications*
Screening	An investor test that considers character, business acumen and level of financial commitment is applied to foreigners acquiring an interest of 25% or more in a business with assets exceeding NZ$100 million or shares (valued at over NZ$100 million) in an existing business.	Threshold is NZ$477 million for Australian investors for business assets not involving sensitive land, farm land or fishing rights.[a]
	'Likely to yield net benefits that are substantial and identifiable' test applied to foreigners acquiring any business that holds sensitive land, farm land or fishing rights.	None
Foreign equity limits	Total foreign acquisition of 10% or more of Chorus (previously part of Telecom NZ) voting shares requires approval by NZ shareholders and Chorus board.	None
	Any foreign investor wishing to acquire 49.9% or more of Chorus voting shares must obtain separate government approval.	None
	Total foreign acquisition of Air NZ shares and acquisition of more than 10% of voting rights must be approved by NZ shareholders.	None

[a] The amount is for 2012 and is indexed annually by the GDP implicit price deflator.

Sources: Chorus (2012); Heatley and Howell (2010); NZ Treasury (nd).

A range of views have been expressed to the Commissions on the FDI arrangements that currently regulate trans-Tasman investment (box C.2).

Box C.2 Participant views on FDI restrictions

Professor Lloyd (sub. 5) argues for the removal of remaining trans-Tasman FDI restrictions, but says that AUSFTA could be an obstacle to this as it commits Australia to granting US investors the treatment it offers to investors from any other country.

Nga Hapū o Niu Tireni/Treaty of Waitangi Partners (sub. 20, p.4) indicate their concern at ‘how the predatory foreign investment funds are given more rights than New Zealand investors under Free Trade Agreements with China and Australia’, arguing that this affects housing affordability and natural resource management.

Greg Mahony and Chris Sadleir (sub. 28, p.4) argue that the CER agenda should focus more on the regulation of FDI and the `identification of the limits to integration’ and processes to ameliorate these.

Telstra (sub. 56) argues that both countries maintain amongst the most open telecommunications industries in the world in terms of foreign ownership, except for legacy restrictions on ownership of the former incumbents. The latter rules are somewhat aligned but less restrictive in New Zealand.

C.3 How restrictive are the FDI regimes?

The OECD’s FDI Regulatory Restrictiveness Index indicates that Australia and New Zealand have more restrictive investment regimes than many other OECD countries (box C.3). For 2012, Australia’s index score was 0.128, New Zealand’s 0.249 and the OECD average 0.083 (where 0 represents full openness and 1 a prohibition on FDI). Of the 55 countries reviewed, New Zealand policies were the 6th most restrictive, while Australian policies were 15th. The Australia and New Zealand ratings were driven primarily by the foreign investment screening regimes in the two countries and, to a lesser extent, by foreign equity limits in specific companies (such as airlines and telecommunications carriers). New Zealand’s screening regime was rated as substantially more restrictive than Australia’s.[2]

2 For Australia, the more restricted sectors of the economy were: air transport (0.475); telecommunications and real estate (both 0.4); maritime transport (0.25); banking (0.2) and insurance (0.175). For New Zealand, the most restricted sectors of the economy were: fishing (0.7); telecommunications and air transport (0.4); agriculture and forestry (0.3) and banking and finance (0.25) (OECD 2012a).

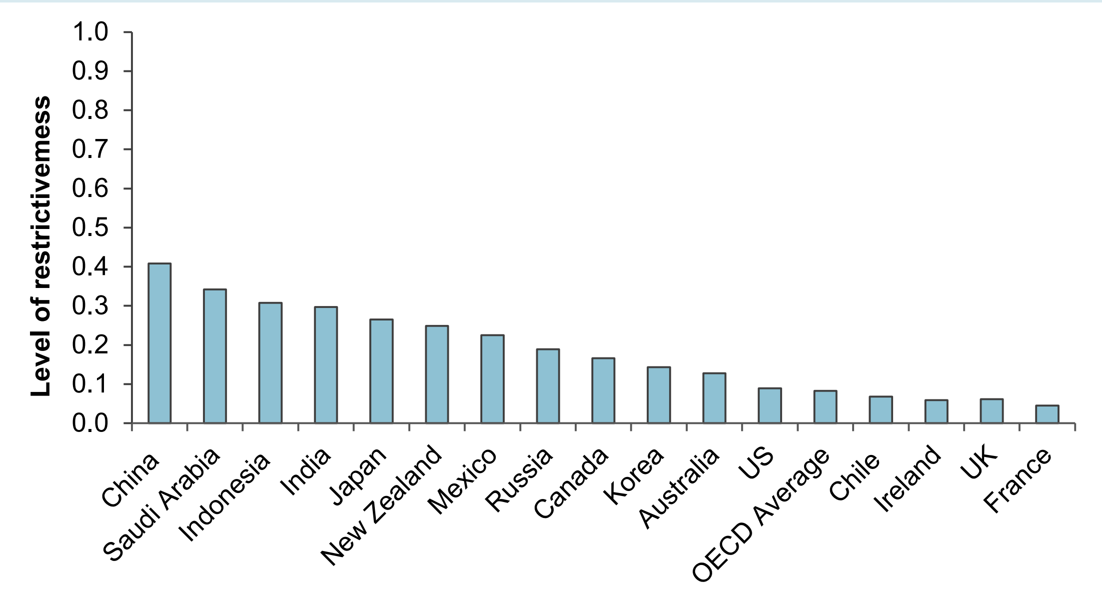
Box C.3 **OECD ratings of FDI restrictiveness, by country**

One attempt to quantify and compare investment barriers is the foreign direct investment (FDI) regulatory restrictiveness index compiled by the OECD secretariat (see figure below).

The index has been calculated for 55 countries (both OECD countries and a number of non-OECD members) and attempts to measure the deviation from national treatment for foreign investors, where 0 represents full openness and 1 a prohibition on FDI. The index rates a range of policies including equity restrictions, screening processes, regulations of key personnel (for example, restrictions on foreign directors) and other requirements imposed on foreign direct investors in 22 sectors of each economy. The rating is based on the stated policies of the governments rather than their application or effect in practice.

While the index provides a heuristic approach by which FDI regimes can be compared on a common basis across countries, according to the compilers of the index, the approach has a number of limitations. The index is not a full measure of a country's investment climate. A range of other factors come into play, including how FDI rules are implemented. Entry barriers can also arise for other reasons not measured, including state ownership in key sectors. There are also some difficulties in ranking countries, and the authors caution that the index should not be used in isolation.

Figure **OECD FDI regulatory restrictiveness index, selected countries, 2012**



Source: OECD (2012a).

Some analysts argue that the Australian and New Zealand FDI regimes are less restrictive in practice than the OECD ratings suggest. For example, a Grattan

Institute report on economic reform priorities for the Australian economy found that there was little evidence that Australia's foreign investment regime was preventing investment in practice and that any gains from its removal would likely be small (Daley, McGannon and Ginnivan 2012). The report pointed to data showing that the vast majority of foreign investment applications in Australia (in value and number) are approved (table C.3).

Table C.3 **Investment applications from all countries, Australia, 2010-11**

Application stage	*Total*	*Real estate*	*Business*
Considered	10 865	na	na
Approved	10 293	9 771	448
- unconditionally	4 606	na	na
- with conditions	5 687	5 683	4
Withdrawn[a]	390	261	128
Exempted	139	na	na
Rejected	43	42	1

a Proposals could be withdrawn for a range of reasons, including because the investment was deferred or the applicant decided not to proceed for commercial reasons. Many of the real estate related withdrawals resulted from applicants submitting multiple applications for a number of properties then withdrawing once one property had been purchased. **na** Data not available.

Source: Adapted from FIRB (2011).

In the year ended June 2011, the Australian Government rejected 43 foreign investment applications and approved 10 293 (a rejection rate of less than 0.5 percent). Of the 43 applications rejected, 42 were in real estate and 1 was a business proposal. The rejected business proposal — the proposed A$8.4 billion takeover of the Australian Securities Exchange by the Singapore Stock Exchange — was the first business proposal rejected since the proposed takeover of Woodside Petroleum Limited by Shell Australia Investments Limited in 2001. The Grattan Institute report also noted that Australia's inflows and total stock of FDI (as a percentage of GDP) have been substantially higher than the OECD average in recent years (table C.4).

Table C.4 **FDI as a percent of GDP, 2008–11[a]**

	Inflows				*Stock*			
	2008	2009	2010	2011	2008	2009	2010	2011
Australia	4.5	2.6	2.6	4.4	29.2	42.5	40.1	36.5
New Zealand	3.8	na	0.4	2.2	39.9	55.2	47.6	46.0
OECD average	2.4	1.6	1.6	1.8	29.1	25.9	30.3	29.7

a Changes in the percentages can be due to changes in the level of stock and the level of gross domestic product. The level of 'stock' reflects the accumulated effects of all previous FDI flows as well as asset prices and exchange rates. **na** Data not available.

Source: OECD (2012b).

Similarly, the New Zealand Treasury has argued that New Zealand's FDI regime is less restrictive than the OECD ratings suggest. A 2009 review of the country's policy settings found that while the FDI restrictions were often rated as restrictive compared with other countries, in practice barriers to FDI were low (NZ Treasury 2009a). The report noted that no business-only applications had been declined since 1984. From 2002 to 2008, 33 applications were declined and 1050 were approved (a rejection rate of 3.5 percent) (table C.5).[3] The report also noted that New Zealand's stock of FDI (as a percentage of GDP) has been substantially higher than the OECD average in recent years (while inflows have varied above and below the OECD average) (table C.4).

Table C.5 **Investment applications from all countries, New Zealand, 2002–2008[a]**

Application stage	*Total*	*Fishing quota*	*Business*	*Sensitive land*	*Business and sensitive land*
Considered	1 609	na	na	na	na
Approved	1 050	1	127	866	56
Not decided[b]	526	na	na	na	na
Rejected	33	0	0	31	2

a For the period 26 August 2002 to 25 August 2008. **b** 526 applications were considered but not decided as they involved exemptions, variations to existing consents, consent if proceeds, no consent required or applications that were either withdrawn by the applicant or lapsed for the want of further information. **na** Data not available.

Source: NZ Treasury (2009b).

On the face of it, these data suggest that the FDI regimes in both countries are not particularly restrictive. However, this may be misleading for several reasons.

First, the data do not show the number of foreign investment proposals discouraged (and not made) because of the screening regimes. Such investments may have made a positive contribution to the host economies.

Second, the data do not show applications modified before submission to improve the chances of approval. This represents a cost to the applicant. It may also impose costs on the host economies, should the modified investment project offer lower benefits than the original.

Third, applications can be made then withdrawn before being assessed. For example, in Australia in 2010–11, 390 applications (around 3.6 percent of all

3 More recent data for the year ending 31 December 2011 shows the New Zealand Government approved 288 and rejected 5 applications (a rejection rate of nearly 2 percent) (OIO 2011).

applications) were withdrawn before a final assessment was made — 128 of these were business applications representing around 20 percent of all business applications made in that year (table C.3). In New Zealand from 2002 to 2008, 526 applications (around 33 percent of all applications made) were not decided for various reasons (table C.5).

Fourth, investment proposals may be approved subject to conditions (imposing costs on the investor or reducing the benefits of the investment). For example, in Australia in 2010-11, just over half of all applications made were approved subject to conditions (table C.3).

Analysts have argued that the New Zealand screening regime, in particular, creates unnecessary uncertainty for overseas investors and that there is potential for improvements, including by adopting elements of Australia's approach (such as greater specificity in the criteria and limits that apply). For example, Heatley and Howell (2010) draw attention to uncertainty associated with the New Zealand screening regime. The authors argue that uncertainty for investors is high because the *Overseas Investment Act 2005* allows decision makers full discretion to weight the factors specified in the Act as they see fit. Further, uncertainty arises because key terms like 'strategically important infrastructure' are not defined in the Act. The outcome of past applications is thus a poor guide to the outcome of any subsequent applications. The resulting uncertainty both discourages applications and increases the cost of applications. It may also make applicants risk averse — encouraging them to pursue projects with lower overall benefits than they would otherwise.

A recent editorial in the *New Zealand Herald* commented on the potential costs of the New Zealand FDI regime:

> The overseas investment regime might be worse in principle than in practice, but the principle is economically unwise and politically dishonest. It promotes the false impression that we can impose any conditions we like on potential investors at no cost to this country. There are always costs, in a lower price offered for the asset, in unnecessary paperwork and professional fees and, most seriously, in investment diverted away from this country by the hurdles we have placed in its path. (New Zealand Herald 2012).

Possible improvements to the regime have been suggested, including the use of a cost–benefit assessment framework which would both remove the discretionary weighting of factors and allow the consideration of other costs and benefits relevant to the national interest (Heatley and Howell 2010). New Zealand could also usefully adopt the Australian approach of specifying equity limits for particular business types, for example airports. Hard equity limits have the benefit of removing the uncertainty inherent in a screening process.

The effects of the CER Investment Protocol

The degree of liberalisation of trans-Tasman investment that will result from implementation of the Protocol is difficult to measure, but is expected to be relatively small. While screening thresholds for Australian and New Zealand investors will be raised, both countries have excluded a range of ‘sensitive’ sectors from the higher thresholds and foreign equity limits on specific businesses will remain (tables C.1 and C.2).

For Australian investors in New Zealand, the higher threshold will reduce the number of business investment proposals subject to New Zealand screening. An analysis of 109 business applications made between January 2006 and July 2010 by Australian investors wishing to invest in New Zealand found that 59 would have been exempt from screening under the higher thresholds (a 54 percent reduction over the period) (Department of Finance and Deregulation 2012). However, this is likely to be a small proportion of the total number of applications made by Australians looking to invest in New Zealand.

Available data suggests that business applications (from all countries) account for only a small proportion of all applications screened in New Zealand. Between 2002 and 2008 only 12 percent of all applications approved by New Zealand regulators were for business investments (table C.5). The remainder were for sensitive land or business applications that included a component of sensitive land — none of which would be exempt from screening under the Protocol.

For New Zealand investors in Australia, the Protocol should, in principle, see some reduction in the number of New Zealand business applications screened, as the threshold rises from A$244 million to A$1062 million. However, given the relatively low level of FDI flowing from New Zealand to Australia in recent years (figures C.1 and C.2), there are likely to be few New Zealand investments valued between A$244 million and A$1062 million that would benefit.

The Protocol is also likely to enhance trans-Tasman investment to the extent it reduces uncertainty for investors from both countries. This could come from two sources — higher thresholds will remove uncertainty for investment proposals exempt from screening and the Protocol’s investment framework may reduce uncertainty by clarifying investor’s rights. As discussed in the next section quantifying these effects is a difficult and sometimes contentious process.

C.4 What are the costs and benefits of existing trans-Tasman FDI restrictions?

The existing restrictions on direct investment flows between Australia and New Zealand impose a range of costs on both countries. The benefits of regulating trans-Tasman FDI flows are less clear.

Costs

There are several types of economic costs associated with restrictions on foreign investment. First, restrictions (such as screening regimes) entail administrative costs to governments and compliance costs for firms. They also increase uncertainty for investors. Second, restrictions (including screening and equity limits) may deter foreign investment and result in higher cost domestic capital being used in its place, raising operating costs. Third, restrictions may deter FDI that would have brought with it firm specific assets, such as human capital, technology and international reputation. Restrictions on FDI can be particularly important in service sectors, where FDI allows trade to occur through the 'commercial presence' mode. For services sectors affected, foreign investment restrictions can result in a range of wider economic costs including:

- less competition (allowing monopoly profits to be made by incumbent firms)
- less diversity and innovation
- higher prices (as foreign service suppliers must enter markets via alternative, less efficient, means than FDI — if they enter at all) (Hardin and Holmes 1997).

The Australian and New Zealand Governments incur administrative costs in screening FDI proposals from each other's investors including the operating costs of the primary screening agencies (the Foreign Investment Review Board (FIRB) in Australia and the Overseas Investment Office (OIO) in New Zealand) and other regulatory agencies (such as competition, environmental and national security authorities).

The screening regimes operated by both countries also impose compliance costs on Australian and New Zealand investors. The NZ Treasury estimates the average cost of a business investment application (including government and legal fees) at around NZ$30 000 and the cost of a land application at between NZ$45 000 and NZ$320 000 (although they note that the actual cost is highly dependent on the complexity of the individual application). Time delays incurred in preparing an application and waiting for the outcome also add to compliance costs for investors.

NZ Treasury estimates that business applications take up to five days to prepare, land applications three to five weeks, while approvals for both can take up to 50 days (NZ Treasury 2009b). The Commissions are unaware of estimates of compliance costs faced by New Zealand investors under the Australian screening regime.

International research supports the idea that FDI restrictions can also impose a range of wider costs on the recipient economy. The OECD has found that higher foreign investment barriers are associated with lower levels of trade and investment (OECD 2006; Lesher and Miroudot 2006) and reduced national incomes (OECD 2005). Restrictions in specific sectors such as telecommunications have been found to be associated with the reduced spread of telecommunications technology and services (Warren 2000 and APEC 2011), higher prices (Warren 2000) and reduced trade and competition in that sector (OECD 2008).

Measuring the wider economic costs to Australian and New Zealand of restricting trans-Tasman direct investment (particularly through screening regimes) is a difficult and contentious methodological issue. Different approaches have been used in recent years in an attempt to quantify FDI screening and equity restrictions and model their economic impacts (box C.4).

The Commissions have attempted to estimate the costs imposed by existing restrictions on trans-Tasman FDI by simulating the effects of the preferential removal of the FDI barriers to trans-Tasman services trade through commercial presence (box C.5).

This modelling is more experimental than the modelling of other aspects of trans-Tasman integration, because of the speculative nature of the estimates of barriers to trade in services and the uncertainty about the definitions and data underlying commercial presence. That said, the estimates used are based on work by the CIE (2010) (box C.4), which has benefitted from previous work published by the Australian Commission (Kalirajan 2000; Doove et al. 2001) and others (Findlay and Warren 2000; Mattoo, Olarreaga and Saggi 2001). Modelling of reduced trans-Tasman barriers to commercial presence trade is discussed in detail in Draft supplementary paper E.

The modelling suggests that the costs to New Zealand of current restrictions on trans-Tasman direct investment in services could amount to 0.4 to 1 percent of real gross national product (GNP). These relatively large effects are projected because Australia provides a large amount of FDI in New Zealand services (for example, 90 percent of the banking sector and a large share of retail).

Box C.4 **The wider economic costs of FDI regimes**

Measuring the costs imposed by a FDI regime is a difficult and contentious task.

The Centre for International Economics (CIE 2004) — in work assessing the impact of increased screening thresholds under the Australia United States Free Trade Agreement (AUSFTA) — argued that screening thresholds increased the equity risk premium on investing in Australia, increasing the cost of capital and deterring inflows of FDI. The CIE assumed that the higher threshold under AUSFTA would reduce the Australian risk premium for US investors, and then modelled this effect on investment flows and economic growth. It found benefits (over a decade) of an increase in real investment in Australia (both domestically and internationally sourced) of nearly 1.4 percent and an increase in real GDP of up to 0.4 percent. However, the approach taken by the CIE has been criticised.

Some commentators have argued that the CIE overestimated the effect of the higher screening thresholds on the risk equity premium and therefore the size of the resultant benefits (Quiggin 2004). Others have argued that the link between screening and the equity premium was not valid and consequently the modelled benefits were imaginary (Dee 2004). Dee argued that the only cost of screening relates to transaction costs.

In a 2010 study prepared for the Australian Department of Foreign Affairs and Trade — quantifying the benefits of global services trade liberalisation — the CIE modelled the effects of global 'overnight' liberalisation of all barriers to trade in services delivered via mode 1 'cross border supply' of services and mode 3 'commercial presence' (CIE 2010). The CIE estimated the liberalisation of commercial presence as the removal of FDI regimes (including screening processes, equity limits of foreign ownership and other ongoing operational limits of foreign investors). The CIE argued that screening regimes could impose costs on the recipient country by reducing competition in domestic markets (by deterring new foreign entrants) allowing incumbent firms to extract monopoly rents, while foreign equity and other operational limits could increase the ongoing unit costs of foreign firms operating in domestic markets.

The CIE found that under global 'overnight' liberalisation of mode 1 and mode 3 barriers, developing countries were, on average, estimated to experience a 0.9 percent gain to real GDP over 2011 to 2025, while developed countries experienced an average gain of 0.2 percent. (Australian real GDP was estimated to be 0.8 percent above baseline in year 2025.) Mode 3 liberalisation of FDI barriers was estimated to account for 52 percent of the real GDP gain by developed countries, and 89 percent of the GDP gain by developing countries (CIE 2010).

Box C.5 **Modelling a reduction in trans-Tasman barriers to FDI**

Various types of barriers can impede trade in services. For commercial presence, barriers limit the establishment or operation of foreign firms. The ANZEA model was used to illustrate the effects of existing barriers, based on information from a report on *Quantifying the benefits of services trade liberalisation* (CIE 2010). Barriers are assumed to have two effects that in combination drive a wedge between efficient cost and price:

- rent-creation, which is assumed to accrue to incumbent foreign investors, equivalent to 18.5 and 15.4 percent premiums on returns to foreign capital on average across services for Australia and New Zealand, respectively (for simplification and by analogy with tariff protection, local suppliers are assumed not to garner rents, but to be less efficient suppliers who benefit from the protection afforded by the barriers)
- cost-escalation, for example, increased administrative costs or blocking potentially lower-cost entrants, which is assumed to increase the costs of foreign and domestic incumbent suppliers, equivalent to 2.4 and 0.9 percent added costs on average across all suppliers of services for Australia and New Zealand, respectively (see table below).

Liberalisation is assumed to: (i) reduce rents that are represented as an ad valorem tax equivalent which accrues to the owners of foreign capital; and (ii) improve the productivity of the affected industries by the amount of the cost-increasing effects.

Table **Estimated barriers to commercial presence**

	Rents on foreign capital		*Cost-increasing effects*	
	Australia	*New Zealand*	*Australia*	*New Zealand*
	%	%	%	%
Trans-Tasman barriers				
Barriers to services[a]	18.5	15.4	2.4	0.9
Barriers to communications	6.9	6.2	4.5	3.1
Barriers with all partners				
Barriers to communications [b]	1.7	2.5	1.1	1.2

[a] Weighted average of barriers for all services industries. [b] Weighted average of barriers for all foreign countries. The weighted average of barriers for all foreign countries in the communications sector is smaller than the equivalent trans-Tasman barriers because relatively low barriers are assumed to apply to capital owned by the US and Europe, for both Australia and New Zealand.

Source: CIE (2010).

(Continued next page)

Box C.5 (continued)

Reducing barriers to commercial presence across the Australian and New Zealand services sectors is projected to generate large benefits for New Zealand, increasing real GNP by up to 1.05 percent if capital is assumed to be highly substitutable (see table below). Gains projected for Australia are more muted, with real GNP increasing by between 0.01 and 0.06 percent. The larger gains in New Zealand are attributable to the relatively large stock of Australian capital in New Zealand.

A reduction in the barriers to commercial presence for FDI in the communications industry was modelled separately as an example of the magnitude of gains in a key sector that provides consumption services to households as well as intermediate input services to businesses. Reducing barriers to trans-Tasman investment in communications produces negligible benefits to Australia, and small benefits to New Zealand. Australians increase their investment in New Zealand, due to the proportionately larger increase in the returns to New Zealand capital (particularly as a result of the removal of cost-escalating barriers). This allows New Zealand's capital stock to expand, and increases the returns to labour for New Zealanders relative to capital.

Removing barriers to all foreign investment in the communication services industry provides larger benefits for both Australia and New Zealand as investment from around the world can achieve a higher rate of return in Australia and New Zealand.

Table **Effects on real GNP of eliminating barriers to commercial presence**

	Australian % change	*New Zealand % change*
Preferential		
Remove trans-Tasman barriers to FDI — all services	0.01–0.06	0.40–1.05
Remove trans-Tasman barriers to FDI — communications[a]	0.00–0.00	0.01–0.02
Non-preferential		
Remove barriers to FDI all countries — communications	0.01–0.02	0.02–0.04

[a] Australian results rounded to zero.

Source: Australian Commission estimates, Draft supplementary paper E.

In Australia, most foreign investment in services is held by countries other than New Zealand. The corresponding costs to Australia of limitations on trans-Tasman FDI in services is much smaller: between 0.01 and 0.06 percent of real GNP (box C.5).

These results are indicative of the costs of maintaining the existing regimes as they apply to the two countries' services sectors only. The full trans-Tasman cost of FDI barriers could be expected to be higher if other sectors of the two economies were included in the modelling (such as manufacturing, agriculture and mining).

The focus of this study is on trans-Tasman economic relations and for that reason the Commissions have focused their analysis on the costs of restricting trans-Tasman FDI flows. However, the FDI regimes restrict direct investment flows from all sources and this imposes additional costs on the two economies.

To illustrate the additional costs to Australia and New Zealand of restricting FDI from all sources, the Commissions have estimated and compared the gains from the preferential removal of all trans-Tasman FDI barriers in telecommunications with the gains from the non-preferential removal of all FDI barriers for all countries in that sector (box C.5). As expected, the preferential removal of trans-Tasman FDI barriers in telecommunications would generate some gains (an increase in real GNP of less than 0.005 for Australia and up to 0.02 percent in New Zealand) while the non-preferential removal of FDI barriers for all countries could double these gains (box C.5).

Possible benefits

The FDI regimes in both countries are intended to achieve a range of benefits (or alternatively, to protect against a range of possible negative impacts). Australia's screening regime considers factors such as the impact of the proposed investment on national security, competition, tax revenues and the environment. The character of the investor is also considered. New Zealand's regime broadly aims to protect New Zealand's interests in relation to the control and ownership of sensitive assets, particularly land.

For investment restrictions to be warranted they would need to have benefits that outweighed the costs. However, in some cases it is uncertain whether restrictions produce significant benefits. For example, concerns about 'food security' are raised as a reason for restricting foreign investment in the agricultural sector, but this argument would seem to have little merit. First, food security appears not to be a significant issue given that Australia and New Zealand are net exporters of food, can readily buy food from other countries and food costs are generally low relative to incomes. Second, FDI in the agriculture and other sectors seems likely to improve food security. A recent ABARES report found:

> Australia's food security is likely to be further enhanced by ongoing foreign investment in agriculture. For the economy as a whole, the flow of foreign funds leads to higher aggregate production in the economy and thus to higher incomes, which improve consumers' capacity to purchase food. (Moir 2011, p. 13)

In other cases, FDI screening processes may duplicate existing domestic regulatory review and approval processes that are designed to achieve the same domestic policy objectives (such as environmental protection or the maintenance of competition in local markets). Where domestic regulations exist to meet local policy objectives it could be more transparent and cost effective to offer foreign investment proposals the same ‘national treatment’ offered to a domestic investment proposal.

There are clear grounds for imposing restrictions that discriminate between domestic and foreign investment in some circumstances, but these are likely to apply to a more limited category of foreign investment proposals. FDI that has the potential to impact on national security, or that is motivated by non-commercial objectives (for example, investment proposals by sovereign wealth funds or state owned enterprises) clearly requires a higher level of screening.

In some exceptional circumstances, there may also be grounds to restrict FDI proposals that are in the commercial interest of a foreign business but not in the economic interests of the recipient country. For example, the 2001 proposal by Shell Australia Investments Limited to take over Woodside Petroleum Limited (the joint venturer in Australia’s North West Shelf LNG project) was rejected on the basis that Shell’s control of Woodside would have allowed it to restrict the development and export of the North West Shelf LNG reserve and expand competing LNG projects it controlled in other parts of the world (Costello 2001).

Conclusion

On balance, existing restrictions on trans-Tasman direct investment impose significant costs on the two countries (including administrative costs on governments, compliance costs on trans-Tasman investors, and (potentially large) wider economic costs on the two economies). At the same time, the benefits of restricting trans-Tasman FDI are unclear and, in many cases, could be better achieved through the use of existing (non-discriminatory) domestic regulatory mechanisms. As a result, there are likely to be gains available to both countries from the liberalisation of existing restrictions on trans-Tasman FDI. Significantly greater benefits are potentially available to both countries from the liberalisation of existing FDI barriers on a non-preferential basis.

C.5 Preferential liberalisation of trans-Tasman FDI

While FDI liberalisation on a non-preferential basis (offering equal treatment to all countries) would generally be expected to generate the greatest economic benefits (as it would allow the fullest flow of capital possible), there is evidence that the preferential removal of restrictions can also generate gains.

The Australian Commission (2010) review of the economic impacts of Australia's bilateral and regional trade agreements (BRTAs) found some evidence that the inclusion of investment provisions within Australia's BRTAs has led to modest increases in investment flows and services trade. An OECD study (2006) found that investment provisions in recent free trade agreements (FTAs) were positively associated with trade and, to a greater extent, investment flows. However, preferential deals require care, recognition that their potential impact is limited and that non-preferential approaches (such as unilateral or multilateral liberalisation) may be more cost-effective and deliver greater benefits (PC 2010).

The Australian Commission (2010) identified some issues to consider before undertaking a preferential investment agreement, to ensure the benefits of preferential action exceed any costs:

- Does the preferential investment deal impose costs? For example, the report noted that Australia has signed up to investor-state dispute settlement provisions in some BRTAs (such as granting foreign investors rights over and above those already provided by the Australian legal system) for which there appear to be few benefits and considerable risks.
- Does the agreement promote or inhibit further multilateral or unilateral liberalisation? Appropriately designed BRTAs can facilitate more extensive unilateral (or multilateral) liberalisation by creating institutional momentum toward liberalisation as well as through the use of MFN and other clauses that require preferential arrangements to be extended. On the other hand, BRTAs can inhibit further reform where they encourage countries to retain barriers for use as bargaining coin in later negotiations or by creating external stakeholders who resist extending preferential treatment to other parties.
- Does the agreement trigger provisions in other trade agreements? For example, the agreement may trigger requirements to extend a preference offered to one country to others through MFN clauses in other BRTAs. This may be a source of further benefits rather than costs.

An additional issue to consider when undertaking preferential liberalisation of FDI barriers is the potential for investment diversion to impose costs on the liberalising country. Some literature suggests that the preferential removal of barriers to investment can reduce welfare for the countries involved if the barriers are of the sort that generate economic rents, but not if they are of the type that increases costs (box C.6).

Box C.6 **Different effects from the preferential liberalisation of FDI barriers**

Where FDI barriers impose real costs on foreign investors (such as equity limits and ongoing operational requirements) preferential liberalisation will unambiguously save resources and increase overall welfare. A reduction in a cost-increasing barrier would reduce costs for investors from the partner country and generate gains to the destination country to the extent that the cost of foreign capital fell. An expansion of FDI from the partner would crowd out investment from third countries (who are excluded by the higher thresholds), but this diversion would not impose a cost on the recipient country. That said, the cost of foreign capital could be lower still (and the gains of liberalisation greater) if protective barriers were removed for FDI from all countries (Adams et al 2003).

Where investment barriers are of the sort to generate rents, then preferential liberalisation could reduce welfare for the liberalising country. Screening can discourage new foreign entrants and allow incumbent foreign firms (and domestic firms) to earn rents (see draft supplementary paper E for a full explanation). Part of the rents accruing to incumbent foreign firms flow to the host country's government as company tax.

Preferentially lowering rent-creating barriers encourages foreign firms that benefit from preferential access to enter markets in the liberalising country. These firms may be supplying services at a higher marginal cost than foreign firms that do not benefit from preferential access, but due to the ongoing FDI barriers, the lower-cost firms will invest in different markets. The preferential access then creates investment diversion.

The new foreign entrants reduce the rents accruing to the incumbent foreign firms and the tax paid by those firms to the host country's government. Tax revenue paid by new foreign entrants may not offset the tax lost since the new entrants will have a higher cost of production, get smaller rents and give lower returns to capital. Some of the rents that were previously taxed are instead transferred to the higher-cost investor from the trade partner. If the loss of tax revenue from the preferential liberalisation is greater than the gains from increased investment and other effects, the host country may experience a net loss.

Costs and benefits of the Investment Protocol

The regulation impact statement (RIS) for the Investment Protocol identified a range of benefits from the increased thresholds and investment framework, including:

- reduced compliance costs, as fewer investment applications are prepared
- reduced uncertainty of an application being rejected at screening
- reduced uncertainty for investments made under the new framework (Department of Finance and Deregulation 2012).

The RIS (without quantifying the costs and benefits) concluded that the Protocol would generate net benefits for Australia and should be implemented. However, as discussed earlier, the size of the benefits of liberalisation are difficult to measure and in some cases disputed.

Gains from reduced compliance costs to trans-Tasman investors under the Protocol are likely to be small. For example, the Commissions have estimated that the higher thresholds under the Protocol would have saved Australian investors in New Zealand around NZ$1.8 million in application costs between January 2006 and July 2010.[4] The reduction in compliance costs for New Zealand investors is likely to be even less (as discussed above, in any given year there are likely to be only a small number of New Zealand applications valued between A$244 million and A$1064 million that will no longer be subject to Australian screening under the Protocol).

Administrative cost savings are also likely to be small. The FDI screening regimes in both countries will continue to operate under the Protocol to review trans-Tasman applications above the new thresholds, as well as investment applications from the rest of the world.

The greatest benefits of the Protocol are likely to flow from an increase in trans-Tasman investment resulting from lower costs and greater certainty and flexibility under the Protocol’s higher thresholds and investment framework. This is difficult to quantify. However, the Australian Commission modelling (box C.5) suggests there could be economic gains even from partial trans-Tasman liberalisation (particularly for New Zealand).

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4 Based on the Australian RIS estimate that 59 of the 109 business applications made by Australian investors in New Zealand between January 2006 and July 2010 would have been exempt from review under the Protocol’s higher thresholds and the New Zealand Treasury estimate of the costs of a business application of NZ$30 000.

The Protocol could also impose some costs. The administrative costs of negotiating the agreement have already been incurred. Implementation costs are likely to be minimal. Another potential cost of the Protocol could come from investment diversion effects due to the preferential nature of the liberalisation (box C.6). The scenario modelled by the Australian Commission shows the Protocol could generate gains for both countries (box C.5). This is a potential area for further study.

The Commissions are not aware of additional costs or risks that may be imposed on either country by the investment provisions included in the Protocol. The Protocol does not appear to include provisions that are likely to inhibit further unilateral or multilateral liberalisation by either country. In fact, the investment framework locks in the agreed level of liberalisation and encourages further bilateral liberalisation (through a ‘ratchet mechanism’ that ensures that any future unilateral liberalisation by either country would automatically be bound by the agreement and cannot be rolled back, and a MFN commitment that ensures that each country extends to the other the benefit of any additional liberalisation undertaken as a result of future agreements with other countries).

Based on the Commissions’ reading of Australia’s and New Zealand’s various BRTAs and bilateral investment treaties (BITs), it appears that the Protocol will not impose any obligations on either country to extend preferential arrangements to any other country. The various BRTAs and BITs either do not have an MFN clause that could require this or, where they do, existing agreements and extensions to those agreements (such as the ANZCERTA) are exempt.

Conclusion

The Investment Protocol is likely to generate net trans-Tasman benefits and should be implemented as soon as practicable.

Even after its implementation, significant barriers to trans-Tasman investment will remain (especially for ‘sensitive’ land in New Zealand, ‘sensitive’ sectors in Australia and through foreign equity limits in both countries). Liberalisation in these areas is likely to bring additional benefits to both countries. The ‘direction of travel’ should be towards national treatment of investors from the other country. There may be legitimate reasons for not proceeding with this to the full extent (for example, for reasons of national security or because of interactions with the Treaty of Waitangi), but where this is the case the policy rationale and the costs and benefits of any restrictions left in place should be transparent.

Given that the greatest benefits from liberalisation of FDI restrictions are expected to come from non-preferential action, it would be desirable to lessen FDI barriers generally. A possible option for this approach is for Australia and New Zealand to extend to some countries the preferential arrangements they have already agreed to provide to each other. This would be in line with the outward-looking approach outlined in chapter 2 and follows the historical precedent of Australia and New Zealand liberalising trade restrictions with one another first and then with other countries.

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