# 3 Selected industry policy issues

Domestic economic reforms and the opening of the Australian economy to greater levels of international competition have been ongoing domestic policy themes, particularly since the 1970s and 1980s. A key component of the policy landscape has been a reduction in assistance provided through protective mechanisms such as tariffs, quotas, product marketing arrangements and local content schemes. At the same time, however, budgetary assistance to industry has become more common and governments have maintained a range of market interventions and less transparent measures affecting industry intended to achieve economic or social goals.

This chapter draws attention to three areas of government intervention that may not be contributing as much as possible to Australia reaching its productive potential or could even be inhibiting it from doing so. The areas considered in this chapter are:

* innovation support programs;
* foreign investment rules; and
* regional development programs and special economic zones.

## 3.1 Innovation support

### Nature of the measure

Innovation is a primary means by which productivity and living standards increase over the longer term. In turn, investment in research and development (R&D) is an important input into the innovation process. Where the benefits of private investment in R&D are not adequately captured by the investor, there is likely to be under provision of R&D from a community’s perspective. In these circumstances, there is an ‘in principle’ case for government support for business R&D.

The strength of the practical case for government support hinges on the designated funding programs being effective in delivering socially beneficial R&D (R&D with sufficient applications beyond the individual firm) that would not be privately undertaken in the absence of public support.[[1]](#footnote-1) Obtaining the information required to determine the ‘right’ level of public support is problematic, not least because individual firms do not have a financial incentive to reveal to government their minimum required level of return from investments in R&D.

Against this background, the Australian Government has provided longstanding support to business innovation through a suite of funding initiatives including generally available R&D tax incentives, specific co-funded R&D to the agricultural sector, R&D-linked funding to the automotive sector, applied industrial research conducted by the Commonwealth Scientific and Industrial Research Organisation (CSIRO) and cross-industry collaborative funding through elements of the Cooperative Research Centres program.

Together, innovation support programs accounted for 38 per cent of total budgetary assistance to all industries in 2012‑13 (chapter 4). There are at least twenty different innovation programs providing some form of business funding support (appendix A).[[2]](#footnote-2),[[3]](#footnote-3) Total business innovation program funding has more than doubled in nominal terms since 1996‑97, with almost all the increase relating to generally available R&D tax incentive programs to business (figure 3.1). In real, inflation adjusted terms, support for business innovation increased by 25 per cent between 1996‑97 and 2012‑13.

The taxation concessions accounted for over 70 per cent of Australian Government funding to business R&D in 2012‑13. The current R&D Tax Incentive program under which the concessions are provided involves targeted R&D tax offsets intended to induce more companies to engage in R&D and to encourage R&D activities that may not otherwise have been conducted (AusIndustry 2014). Companies self-assess eligibility of their R&D activity against a set of prescribed criteria. Compliance auditing is used to manage funding risks. While the definition of qualifying R&D activities does not attempt to explicitly quarantine or target funding support to R&D that would not have taken place without that support, it does provide a lower subsidy to the performance of R&D by larger firms (that is, firms with a turnover of $20 million or more).

Figure 3.1 Budgetary R&D funding support to industry**a**

$ billion (nominal)

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a Prior to 1 July  2011, payments made under the R&D tax offset program were exempt from tax. In addition, companies that claimed the offset were unable to claim deductions for the R&D expenditures concerned. This was because payments made under the offset had already provided these companies with a benefit equivalent to the value of these deductions. The absence of these deductions constitutes a negative tax expenditure included in the Other R&D support category.

*Sources*: Based on data from Australian Treasury Tax Expenditures Statement, Commissioner of Taxation Annual Report and Commission estimates.

### Likely impacts of the measure

A series of studies and inquiries into the provision of R&D support have, amongst other things, recognised that there was an in-principle case for assistance but there was a need to improve inducements rates of the R&D tax concession program to ensure net social benefits accrued from the scheme (BIE 1993, IC 1995; Lattimore 1997; CIE 2003; PC 2007). Another study found that government assistance had more influence on the innovation behaviour of small firms than of large firms (ABS 2007, p. 50). Findings related to R&D support are somewhat similar to the old adage for advertising expenditure: ‘that it is likely 50 per cent is wasted, but no one knows which 50 per cent’.

The studies also found that much of Australia’s R&D activity involved product-based incremental change, with benefits more likely to be specific to the individual firm and likely to involve lower levels of spillovers, rather than truly novel and technically risky research (see for example, PC 2007, p. 383).

Although the studies took account of the opportunity cost of providing the R&D tax concession, they did not make it clear whether the tax concession affected the mix of R&D conducted or whether it induced *new* firms to establish and conduct R&D (a stated objective of the current scheme). An evaluation of the current R&D Tax Incentive program would shed more light on these issues and whether the inducement effect is likely to render this program socially beneficial.

### Recent policy development activity

The Australian Government commissioned a review of Australia’s national innovation system in 2008 (Cutler 2008). Identifying again a range of shortcomings with the existing arrangements, the review recommended replacing the tax concession with a more generous tax credit scheme on the grounds that the scheme would induce higher levels of R&D by small firms in particular. A modified version of these recommendations was subsequently adopted.

The definition of eligible R&D was also re-aligned to focus on more novel and technically risky innovation (box 3.1). Although the impacts associated with the re-designed program have yet to be formally evaluated, indications of funding trends suggest that the changes to R&D definitions may not be acting to restrict the types of activities being claimed and, as a consequence, the scheme may not be targeting high spillover R&D as intended.

In particular, the higher hurdle presented by the re-aligned definition could be expected to reduce the overall funding requirement (tax revenue foregone) of the scheme and the number of firms accessing it (despite a higher subsidy rate afforded eligible R&D than afforded in the previous scheme).[[4]](#footnote-4) Although the number of firms accessing the scheme appear to have declined,[[5]](#footnote-5) 2013‑14 portfolio budget statements data (not shown in figure 3.1) indicate program funding for the R&D tax incentive in its first year of operation (2011‑12) was nearly 20 per cent higher than the previous program year. Estimated revenue forgone in year two was higher again (Australian Government 2013a).[[6]](#footnote-6)

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| Box 3.1 Eligible R&D activities under the current R&D Tax Incentive scheme |
| Core R&D activities are experimental activities whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:   * is based on principles of established science; * proceeds from hypotheses to experiment, observation and evaluation, and leads to logical conclusions; and * is conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services). |
| *Source*: AusIndustry (2012, p. 7). |
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### Possible directions for future policy development

Public support for business R&D under current arrangements has not reduced the call on public funds that might have been anticipated by amendments to the definition of R&D and calls into question whether any refocusing on more novel and technically risky R&D activity has been induced. Accordingly, the R&D tax incentive could simply be viewed as a general tax cut to the sub-set of some 8300 companies registered to claim the concession (in 2011‑12). Placed in context, the $2 billion in public funding for the R&D Tax Incentive in 2012‑13 represented 3 per cent of the $68 billion of company tax collected in that year (Australian Government 2013b).

This suggests there may be merit in considering alternative approaches for supporting R&D. For example, an assessment of the economic impacts of a reduction in company taxes by an amount equivalent to current R&D concessions could provide a point of comparison for analysing the relative merits of R&D tax concessions.

A more direct approach could be to consider tightening the design of the current arrangements, however, the history of such changes to tax laws is not impressive. Blunt instruments, such as using an historical R&D-to-sales ratio as a base against which genuinely additional R&D can be compared, are applied in other countries. An even simpler (although possibly less effective) alternative would be to use an historical average R&D spend as the base to compare increases in activity. This approach featured in the earlier R&D tax concession program but has not been carried over to the current program.

While R&D tax concessions remain capable of malleable interpretation for inflating tax claims, they diminish the in-principle case for *some* public support.

## 3.2 Foreign investment rules

Foreign investment rules may confer protection to domestic firms by restricting foreign competition. They can also impose costs on Australian firms by restricting their access to capital and strategic and other partnerships. International comparisons by the Organisation for Economic Co-operation and Development (OECD) indicate that Australia has a more restrictive regime than many other developed countries.

### Nature of the measure

For all of its past, and for the expected future, Australia has drawn on foreign capital as a source of finance for new investment. Net foreign capital inflows to Australia have trended upwards over the last three decades and have increased substantially with the mining investment boom (figure 3.2, left hand panel). Over this period, domestic savings have also risen to represent 70 per cent of Australia’s capital requirements. But this has not been enough to support the total capital needs of globally significant export-oriented developments — including in the resource areas of coal, iron ore and natural gas.

Accumulated inflows have typically taken the form of portfolio investment (in equities and debt securities). This investment raises foreign equity in Australian-located businesses. Portfolio investment, where the investor has no appreciable control over the operation of the enterprise, currently represents about 55 per cent of Australia’s inward foreign investment stock (figure 3.2, right hand panel).

Foreign capital inflows have also involved direct investment — where the investor owns at least 10 per cent of an enterprise and is deemed to exercise some degree of control (ABS 2004). While direct investment inflows have more than doubled over the last 10 years, the relative importance of direct investment has declined from 36 per cent of the inward foreign investment stock in 1988‑89 to 27 per cent in 2012‑13. Reinvestment of earnings of mining firms in Australia, to finance mine expansions and new developments, has contributed to the increase in this category over time.

The remaining inflows have comprised financial derivatives (reflecting the highly traded nature of the Australian dollar), currency and deposits, and trade credit.

Figure 3.2 Investment funding source and inward foreign investment stock

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| Sources of investment funding ($b nominal)a | Inward foreign investment stock (per cent) |
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a The substantial increase in national saving since 2002‑03 largely reflects changes in household saving. Foreign borrowing data are net of the large outflows of foreign capital (Australian offshore investment), particularly over the period since 2002‑03.

*Sources*: ABS Cat. no.’s 5206.0 and 5302.0.

Australia’s inward and outward foreign investment has evolved against the background of progressive financial market liberalisation which has allowed foreign and domestic investors to diversify their investment portfolios and maximise risk-adjusted returns.[[7]](#footnote-7) The benefits of that diversification would accrue across a disparate group of foreign and local investors including individual firms (both Australian and foreign owned), pension funds and general fund managers.

The Australian Government regulates foreign investment through the *Foreign Acquisitions and Takeovers Act* (FATA)*1975* (Cwlth) and specific legislation in certain ‘sensitive’ sectors or companies (box 3.2).[[8]](#footnote-8)

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| Box 3.2 Foreign investment restrictions in ‘sensitive’ sectors |
| Specific legislated foreign investment and regulatory requirements in sensitive sectors include:   * foreign ownership in the banking sector must be consistent with the *Banking Act 1959*, the *Financial Sector (Shareholdings) Act 1998* and banking policy; * aggregate foreign ownership in an Australian airline (including Qantas) is limited to 49 per cent (with any one foreign holding capped at 35 per cent); * the *Airports Act 1996* limits foreign ownership of some airports to 49 per cent, with a 5 per cent airline ownership limit; and cross-ownership limits (where a foreign investor owns more than 15 per cent of Sydney airport) between Sydney airport and either Melbourne, Brisbane or Perth airports; * the *Shipping Registration Act 1981* requires a ship to be majority Australian-owned if it is to be registered in Australia; * aggregate foreign ownership of Telstra is limited to 35 per cent and individual foreign investors are only allowed to own up to 5 per cent; and * foreign ownership in the media sector (television, newspapers and radio) above 5 per cent requires notification and approval, regardless of value.   Foreign non-residents can only invest in Australian real estate if that investment adds to the housing stock. Established dwellings cannot be purchased. Temporary residents can only buy an established dwelling if it is used as their residence. |
| *Sources*: Australian Treasurer (2013, p. 3); FIRB (2012a, b). |
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Regulatory restrictions on investment typically involve quantitative share ownership limits or the imposition of operational conditions in a small number of sectors or companies such as Qantas, through the *Qantas Sale Act 1992* (Cwlth), and BHP-Billiton, through conditions placed on the merger between the two companies by the Foreign Investment Review Board (FIRB) (Costello 2001).

The FATA Act contains notification and approval requirements for acquisitions of a substantial or controlling interest in a corporation or business above $248 million for private investors from most countries. However, investors based in the United States or New Zealand receive more favourable treatment with a higher notification threshold of $1078 million.[[9]](#footnote-9),[[10]](#footnote-10),[[11]](#footnote-11) The FIRB reviews or screens each notifiable foreign investment application against a *national interest test*. National interest considerations relate to national security, competition, other government policies (including taxation and environmental), impacts on the economy and community, and the character of the investor (Australian Treasurer 2013, pp. 7–8). The Act provides the Australian Treasurer with the power to block proposals or apply conditions to the way they are implemented (FATA Act 1975).

In 2012‑13, the total value of foreign investment proposals approved by the FIRB was $135.7 billion (a 20 per cent decline on the 2011‑12 value) with 60 per cent of this directed at non-real estate activities, primarily in: mineral exploration and development ($45.1 billion); services ($25.9 billion); and manufacturing ($6.5 billion). Agricultural investment proposals approved by FIRB ($2.9 billion) accounted for just 3 per cent of non-real estate approvals in 2012‑13 (FIRB 2014).

Australia is a signatory to several multilateral and bilateral investment agreements which condition or govern the foreign investment policy environment. These include the:

* WTO Agreement on Trade Related Aspects of Investment Measures (TRIMS);
* OECD Code of Liberalisation of Capital Movements (one of the few legally binding instruments of the OECD) which provides a framework for the progressive removal of barriers to the movement of capital; and
* provisions contained in Australia’s 27 Bilateral Investment Treaties (BITs) and the investment chapters of the seven bilateral trade agreements which deal with investment flows between Australia and counter-signatories.

### Likely impacts of the measure

Very few foreign investment proposals are rejected by the FIRB. In fact, only three business-related (non-real estate) proposals have been rejected (on national interest grounds) since 2001.[[12]](#footnote-12) However, this outcome does not necessarily reflect the restrictiveness of Australia’s foreign investment regime. The way the regime is applied may act to discourage potential investment proposals from being considered or advanced to the notification stage.

It also does not recognise the explicit limits placed on investment in sensitive sectors which, in effect, means that some investment options are not advanced. For example, the foreign ownership limit provisions in the *Qantas Sale Act 1992* are claimed to be limiting Qantas’s ability to form strategic alliances with overseas airlines and access foreign capital (Joyce 2013).[[13]](#footnote-13) Telecommunications is another sector in which continuous offshore investment interest has been seen. Even though actual foreign ownership levels have for some time been beneath the legislated limits, this does not mean the limits have not acted to discourage foreign investment.

#### International comparisons of FDI regimes

International comparisons of FDI regimes indicate Australia’s regime is relatively restrictive. The OECD periodically publishes comparisons of regulatory restrictions on inward foreign direct investment across member and selected non-member countries. Four broad categories of restrictions are considered: limitations on foreign ownership; screening or notification procedures; restrictions on employing foreign personnel; and management and operational restrictions (OECD 2010).

The latest results from the OECD show Australia’s foreign direct investment regime ranked 16th of 58 countries in 2013 and was rated as more stringent than all the other developed member countries except Korea, New Zealand and Canada (OECD 2014).

Australia’s restrictiveness index score of 0.128 in 2013, compared to the OECD average of 0.069.[[14]](#footnote-14) Equity restrictions and screening and notification requirements were the largest contributors to Australia’s score and rank. In line with the special sectoral requirements mentioned above, the greatest FDI restrictions (in order of restrictiveness) were assessed to be in: air transport (0.475); telecommunications (0.4); real estate investment (0.4); maritime transport (0.25); banking (0.2); media (0.2); radio and television broadcasting (0.2); and other media (0.2).

The restrictions in Australia’s foreign direct investment regime are likely to make Australia a less attractive destination for foreign direct investment than would otherwise be the case. However, on their own, the OECD indexes are not comprehensive measures of restrictions in place or of how the rules are implemented. The indexes should therefore be treated with care. Indeed, Australia, Canada and New Zealand have an inward FDI stock relative to GDP that is larger than in most other OECD countries even though the three countries are among the most restrictive according to the OECD index.

There are fewer restrictions around most portfolio investment. Where they exist, they mainly relate to conditions associated with privatisation of government business enterprises (many of the restrictions listed in box 3.2) and the quarantining of the initial sale of shares in those privatisations to local investors. In the former case, conditionality could limit the capital raising capability of the business concerned and impede its commercial viability. In the latter case, any sales preferences to Australian residents and subsequent on-selling of securities to foreign interests could imply transfers from the Australian Government and create perceptions of sub-optimal privatisation strategies.

Depending on the nature of the restrictions and the operating environment of the businesses concerned, the various regulations and associated restrictions affecting foreign investment into Australia can impose costs on both affected businesses and the broader economy. Such costs could include: the loss of business and strategic partnership opportunities; restricted access to foreign markets; forgone productivity gains available from access to foreign technology and know-how; lower levels of competition that erodes incentives to innovate, invest and raise productivity; as well as fewer employment and income earning opportunities.

### Recent policy development activity

Foreign investment restrictions have been the subject of numerous Parliamentary reviews in recent years, generally aimed at responding to the perceptions of the day. In March 2009, the Senate Standing Committee on Economics was tasked with conducting an inquiry into foreign investment by state-owned enterprises (SSCE 2009). The Committee, amongst other things, recommended a need for greater transparency through provision of clearer criteria for the national interest test. This recommendation was noted by the Australian Government.

In 2011, an examination of Australia’s current framework for foreign investment by the Senate Standing Committees on Rural and Regional Affairs and Transport considered that there were major deficiencies in the framework (SSRRAT 2013, pp. xxi-xxii). The committee recommended more stringent foreign investment screening processes, particularly in the agricultural sector.

Recently, the House of Representatives Standing Committee on Economics announced an inquiry into Australia’s foreign investment policy as it applies to residential real estate (O’Dwyer 2014). The terms of reference for the inquiry include examining: the economic benefits of foreign investment in residential property; whether such investment is directly increasing the supply of new housing; how Australia’s foreign investment framework compares with international experience; and whether the administration of that framework relating to residential property can be enhanced. The Committee is to report in October 2014.

### Possible directions for future policy development

There has been no comprehensive review of impediments to flows of foreign capital, inwards or outwards, in recent times despite the continued significance of foreign investment to an economy with Australia’s high development potential. It is possible that issues relevant to impediments to foreign investment arise in the course of the current Financial System Inquiry (Abbott 2013), but given its political significance, it is unlikely that any review will willingly look at the issue holistically without being specifically tasked to do so.

Aside from political considerations, there are other reasons for scrutiny of foreign investment, including: transfer pricing and tax avoidance and national sovereignty matters (particularly where the investor is a state-owned enterprise).

In view of the importance of foreign investment as a source of funding for new investment in Australia and the difficulty in establishing objective economic criteria for determining whether a particular investment is desirable, there may be merit in a holistic review. Such a review could consider tax laws, competition laws and the individual sectoral restrictions on foreign investment. In doing so, it could consider the effectiveness of current laws and administrative arrangements specific to particular capital-related issues and the potential for improvement.

Such a review may also consider whether to apply the same notification threshold to all countries in accordance with the WTO’s Most Favoured Nation principle. This would involve uniform application of the lower threshold currently applying to the United States and New Zealand (and soon to apply to Korea and Japan) under bilateral trade agreements.

## **3.3 Regional development and special economic zones**

### Nature of the measure

Measures to promote regional development within countries can take a number of forms, including:

* special economic zones (sometimes referred to as ‘free trade zones’), in which tariff concessions and other trade and finance facilitating incentives are made available and exemptions granted from some workplace and environmental regulations;
* geographically targeted taxation concessions;
* public provision of ‘seed’ infrastructure and services within a region, and
* promotion and support of a region as a ‘cluster’ (a geographic concentration of interconnected companies and institutions, often in a particular field).

This section focuses on the first of these measures.

Special economic zones have come into widespread use relatively recently. Since the establishment of the first ‘modern’ free trade zone in Ireland in 1959, the International Labour Organization (ILO) has estimated that by 2006 approximately 3500 such zones had been established in around 130 countries, employing around 66 million workers (ILO 2007). Such zones now form a substantial part of global supply chains.

In Australia’s case, there has been one attempt to establish a special economic zone. In addition, Australian governments have implemented a variety of other measures that favour activities in designated areas, usually with the intent of promoting regional development (box 3.3).

In other countries, special economic zones have been used for a range of reasons, including:

* as a testing ground for experimental (often market liberalising) policies that are not permitted at the national level (including in China and, more recently, in Japan through its ‘strategic special zones’);
* to support wider economic reform and a shift from inward to outward-looking policies (including in South Korea, Taiwan, Malaysia and Thailand);
* to reduce the anti-export bias of high tariffs (such as in Mexico through its *maquiladora* program);
* to act as a ‘pressure valve’ to alleviate unemployment (including in Tunisia and the Dominican Republic); and
* to attract foreign investment (this is the focus of many new zones, particularly in the Middle East) (OECD 2007; FIAS 2008; East Asia Forum 2013).

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| Box 3.3 Measures intended to promote regional development in Australia |
| Various methods have been implemented with the intention of promoting regional development in Australia, including:   * *Special economic zones* — the (defunct) Darwin Trade Development Zone (1985 to 2003) is Australia’s only experience of a special economic zone to date — intended to attract industry to Darwin (Robins 1988; AustLII 2014); * *Taxation concessions* — such as the Taxation Zone Rebate, introduced in 1945 to recognise the disadvantages to residents in specific areas of Australia; * *Public provision of infrastructure or services* — such as the Ord River Irrigation Area, intended to establish a large scale area for irrigated agriculture in an isolated area (Department of Natural Resources 1976), the ‘growth centres’ of Albury-Wodonga and Bathurst-Orange, and the ‘new city’ of Monarto (in South Australia) (Freestone 2010); and * *Support for clusters —* such as the Multifunction Polis (in Adelaide), intended to be a futuristic city with high technology industries to help Australia expand its technology base (Parker 1998).   In addition to measures such as these, the Australian Government has provided and continues to provide a range of budgetary assistance programs with an explicit or implicit geographic dimension; for example, the Tasmanian Freight Equalisation Scheme is intended to subsidise the cost of freighting qualifying goods by sea between Tasmania and the mainland. |
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### Likely impacts of such measures

Special economic zones effectively provide preferential treatment for eligible businesses (or individuals) operating within the scope of the measure. Such preferential treatment can be either direct — in the form of tax concessions, grants and subsidies, and exemptions from certain regulations — or indirect — in the form of an increased level of government provision of infrastructure or public services. The impact is to lower the operating costs or increase the revenues of firms within the scope of the measure relative to the level they would otherwise have been.

This preferential treatment comes at a cost to other businesses — those outside the scope of the measure — that may be competing for scarce labour and capital resources, and to businesses and households that may have to pay higher taxes or other government charges to fund the preferential treatment.

The main expected impact of such measures is typically couched in terms of achieving a permanent increase in economic activity above the level that would otherwise have prevailed (the longer-run dynamic impact). Whether such an increase is achieved can depend on whether the measure has a trade-creating or trade-diverting effect — that is, whether it increases economic activity in the economy as a whole or simply diverts some activity from outside the designated zone into the designated zone.

Measures that seek to ‘force development’ in situations not matched by an underlying potential competitive or comparative advantage, or where there are no clear regulatory or technical impediments to growth, have a heightened risk of imposing net costs on the community.

In this regard, the OECD observed that the use of special economic zones as a regional development tool has often been costly because such a motivation ‘often reflects political and social rather than economic and technical considerations’ (2007, p. 40). It further noted that the development of zones in remote locations ‘tends to require relatively high investments in infrastructure’ and that:

… job creation has not always been the result … [because] … while labour costs may be lower in some remote areas, this may not compensate for weaker linkages to markets and unreliable supporting services. (OECD 2007, p. 40)

Thus, measures such as the Darwin Trade Development Zone, the Ord River Irrigation Area, the ‘new city’ of Monarto and the Multifunction Polis — not one of which appeared to be aligned with any underlying potential competitive or comparative advantage — were unable to sustain a significant increase in economic activity following inception.

On the other hand, measures that are more likely to be associated with successful outcomes are those based on a potential competitive or comparative advantage or the removal of regulatory or technical impediments to growth. However, even in such cases, some caution appears warranted.

The Albury-Wodonga Development Corporation — established in the early 1970s to foster economic activity in the Albury-Wodonga ‘growth centre’ — is credited by some with accelerating the area’s population growth based on its advantage as a commercial centre situated on the main Sydney-Melbourne road and rail corridor (Freestone 2010). Nonetheless, despite its advantageous location, outcomes fell well short of expectations: the initial (1973) target to increase the population to 300 000 by the year 2000 was lowered in 1977 to ‘around 150 000’ and again in the early 1990s to 106 000 (slightly above the current population) (Freestone 2010).

### Recent review and policy development activity

There have been numerous studies in recent years on special economic zones and regional development more broadly (box 3.4). In general, these studies have cautioned against the use of special economic zones. Some have noted the adverse effects of using zones as a way to achieve regional development objectives in view of the potentially high costs to government and negative effects outside the designated region.

Common themes emerging from these studies are that special economic zones:

* divert resources;
* have a significant risk of imposing net costs on the community; and
* are no substitute for broader domestic economic reform.

Moreover, if a measure failed to improve the underlying competitiveness of a region, there may be pressures on governments to maintain the support — rather than remove it (IC 1993).

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| Box 3.4 Some cautionary comments from policy reviews on special economic zones and regional development |
| A number of reports on special economic zones and regional development policies have been produced in recent years by a broad range of institutions:   * an OECD (2007) report on export processing zones examined their past and future role in trade and development — it concluded such zones are ‘suboptimal policy’ compared to general economic reform to improve the business environment (p. 6) and their use as a regional development tool ‘has often turned out costly’ (p. 40); * a World Bank (Farole and Akinci 2011) report on special economic zones reviewed the progress of such zones and looked into their emerging challenges and future directions — it noted the many zone failures and found that to be successful ‘the commercial case must be present’ and that case ‘must be based on sustainable sources of competitiveness, not on fiscal incentives’ (p. 11); * a Facility for Investment Climate Advisory Services — the investment advisory service of the World Bank (FIAS 2008) — report examined 30 years of experience of special economic zones — it observed that ‘one of the clearest lessons learned … is that zones cannot and should not be viewed as a substitute for a country’s larger trade and investment reform efforts’ (p. 5) and that zones are more likely to fail financially if they feature ‘massive government capital outlays … and/or, if they receive subsidized inputs’ (p. 38); * a Grattan Institute (Daley and Lancey 2011) report explored the factors that drive regional development in Australia — it concluded that government spending ‘cannot make economic water flow uphill’ and that regional development policies should be clearly recognised as ‘subsidies to be justified on equity or social grounds, rather than hoping that they will generate self-sustaining economic growth’ (p. 3); * the New South Wales Parliament (2012) Legislative Assembly Committee on Economic Development reported on the viability of special economic zones for promoting growth, employment and investment in regional New South Wales — it found persuasive arguments that zones ‘disadvantage neighbouring regions, … detract from effective competition and may promote inefficiency’ (p. 44); and * a Regional Australia Institute (2013) report focused on policy issues surrounding the future of Australia’s northern regions — it stated that a key policy challenge is to create an approach that ‘devolves genuine responsibility to people in the regions [and] incentivises their leadership’ (p. 8).   The Commission’s direct forebears also produced some related reports:   * the Industry Commission (IC 1993) reported on impediments to regional development — it noted the importance of ‘reforming labour markets, … improving infrastructure provision and minimising ‘red tape’’ (pp. xxxii-xxxiii); and * the Industries Assistance Commission (IAC 1987) reported on export concessions — it concluded that trade zones ‘are unlikely to yield economy-wide benefits’ (p. 40). |
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In Australia, a number of policy processes related to special economic zones and regional development have been proposed or are currently underway.

* The Joint Select Committee on Northern Australia is currently considering policies for developing the parts of Australia which lie north of the Tropic of Capricorn. The committee is to deliver its final report to the Australian Parliament on or before 6 July 2014. Its recommendations will inform a White Paper on developing northern Australia (see below) (Parliament of Australia 2014).
* Some submissions to the committee have expressly called for northern Australia to be declared a special economic zone — for example, Australians for Northern Development and Economic Vision stated that ‘optimal policy is to create one [special economic zone] across all of Northern Australia … [with] reduced State/Territory and Federal taxation — stamp duty, payroll tax, income and company tax’ (Parliament of Australia 2014, Inquiry into the Development of Northern Australia, sub. 147, p. 3).
* In February 2014, the Australian Government announced that the preparation of a White Paper on developing northern Australia was underway.

### Possible directions for future review and policy development

The history of special economic zones is not a positive one. While it can be seen as an understandable tool for trialling a policy intended to apply more widely, a danger is that such wider application of successful trials may never occur. Further, firms advantaged by any tax or other support that is provided may have no basis for staying if that support is removed, creating an incentive to make the support permanent.

Efficient resource allocation is undermined.

And where the objective is to encourage development in regions currently considered unattractive for investment, it is crucial that the potential net benefits are well established (and optimism bias corrected) before expectations are raised. The lack of analysis is one of the most problematic aspects of calls for regional or special economic zones.

1. Recognition of market impediments to optimal R&D outcomes led to an agreement signed by members of the World Trade Organization which created a temporary ‘safe harbour’ for certain R&D support programs against the imposition of countervailing measures by other countries. However, the safe harbour status of R&D, regional development and environmental compliance subsidies was originally only intended as a temporary measure scheduled to expire in 2000 (WTO 1994). [↑](#footnote-ref-1)
2. The share of direct government funding of business R&D in Australia has fallen from 4.9 per cent in 2001 to 1.8 per cent in 2010. These figures compare with the OECD average of 6.8 per cent in 2001 and 8.6 per cent in 2011 (OECD 2013). [↑](#footnote-ref-2)
3. A Single Business Service Delivery Initiative was announced in the 2014‑15 federal budget which will consolidate a number of innovation programmes from 1 July 2014. In 2009, the Framework of Principles for Innovation Initiatives was adopted by the Australian and State and Territory governments to enhance consistency and improve the overall accessibility and efficiency of government innovation measures across Australia. [↑](#footnote-ref-3)
4. The subsidy under the R&D tax incentive program is equivalent to a 150 per cent tax deduction for firms with turnover less than $20 million per year and a 133 per cent tax deduction for firms with turnover above $20 million per year. This compares with a 125 per cent basic tax deduction (175 per cent for eligible R&D above a 3 year average) under the previous program. [↑](#footnote-ref-4)
5. Trends in the number of companies accessing the program were consistent with a stricter definition of R&D with this indicator showing a 9 per cent decline between 2010‑11 and 2011‑12 (Innovation Australia 2013, 2014). [↑](#footnote-ref-5)
6. The 2014‑15 Portfolio Budget Statements indicate that data related to budgeted expenditure on the R&D Tax Incentive are not available. [↑](#footnote-ref-6)
7. Deregulation of Australia’s financial system began in the 1980s and globalisation of product and financial markets has seen considerable growth in Australian investment abroad. Australia’s stock of foreign assets increased more than ten-fold between 1990 to 2013, greater than the eight-fold increase in Australia’s stock of foreign liabilities over the same period (ABS Cat. no. 5302.0). [↑](#footnote-ref-7)
8. The general application of the merger provisions of the *Australian Competition and Consumer Act 2010* can, in principle, also act as a restriction on foreign direct investment. [↑](#footnote-ref-8)
9. For investment in prescribed sensitive sectors the general (or a lower) threshold applies to all countries. [↑](#footnote-ref-9)
10. Where an investor is a foreign government or an associated state-owned enterprise or sovereign wealth fund, all direct investment proposals must be notified to FIRB. According to the Australian Government, the FIRB looks for evidence of a commercial basis for the investment when assessing these particular proposals (Australian Government 2011, p. 5). [↑](#footnote-ref-10)
11. Investors from the Republic of Korea and Japan will also be eligible for the higher threshold when the recently negotiated bilateral agreements come into force. [↑](#footnote-ref-11)
12. One of these proposals was in the resource sector (the proposed Shell takeover of Woodside Petroleum in 2001), one in financial services (the proposed Singapore Stock Exchange takeover of the Australian Stock Exchange in 2011) and one in agriculture (the proposed Archer Daniels Midland takeover of GrainCorp in 2013). [↑](#footnote-ref-12)
13. Importantly, foreign shareholding limits have not prevented Qantas from entering into strategic alliances in the past. For example, the most recent alliance with Emirates involves no equity stake in Qantas. Similarly, the earlier alliance between Qantas and British Airways (BA) began with a 25 per cent foundation investment by BA but continued long after BA had sold out of its equity stake. [↑](#footnote-ref-13)
14. A figure of 1 represents a completely restricted regime while 0 signifies a completely unrestricted regime. Some care needs to be exercised in these comparisons as European Union (EU) member countries apply stricter controls on non-members than other EU countries. Accordingly, the effective level of restrictiveness depends on whether FDI is from within or from outside the EU. [↑](#footnote-ref-14)