

Liberalising Australia's Foreign Investment Policy

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SINCE the early 1980s, global foreign investment flows have grown four times faster than world output and three times faster than world trade.¹ The economic impact of foreign investment and multinational corporations (MNCs) on host economies has been subject to vigorous policy debate this century. For example, Lenin, the founder of the former Soviet Union, claimed that foreign investment exploited host countries and represented the final stage of global capitalism. But this hostile view has been rejected by many governments in both the developed and developing world, including communist China, whose high double-digit growth rates posted in recent years undoubtedly stem partly from investment from Western nations and the concomitant new technology and expertise it has transferred.

Even though governments of all ideological persuasions around the world are actively vying to increase their relative shares of expanding transnational investment flows, the Australian government, through the operations of the Foreign Investment Review Board (FIRB), continues to discourage certain forms of foreign investment, particularly in the financial, media, real estate and transport sectors of the economy. Indeed, there is a widespread view, often expressed by the Australian Democrats, that Australia's foreign-investment policy is not restrictive enough, particularly as it relates to foreign takeovers of Australian enterprises.

On what economic (as opposed to political) grounds is the Australian government curbing foreign investment? And why should foreign investors be treated any differently from domestic investors as generators of income? In reality, the further liberalisation of foreign investment, including the abolition of the FIRB, would lead to significant national economic welfare gains. Present foreign-investment policy is economically costly insofar as it deprives the economy of additional economic activity and so limits growth.

The Nature of Foreign Investment

Analysts of the impact of foreign investment on host countries usually make an important distinction between direct and portfolio foreign investment. Regulations governing cross-border investment flows generally apply to direct foreign investment. For

¹ *The Economist*, 27 March 1993. Oxelheim (1993) also contains a discussion of general international investment trends.

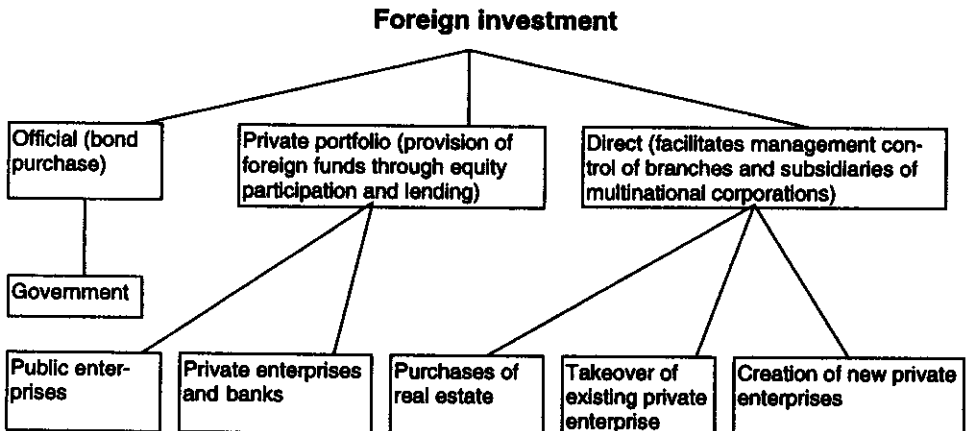
measurement reasons, foreign investment is classified as 'direct' if at least 10 per cent of a firm's equities are owned by foreign shareholders, since this share is judged to confer a significant degree of foreign management control over the routine operations of the enterprise. It also includes real estate acquired by foreigners.

'Portfolio' foreign investment, in contrast, does not have management control implications and covers foreign purchases of the equities of Australian firms or debt instruments issued by Australian entities for portfolio investment purposes.

Direct foreign investment has always been a major component of total foreign investment in Australia. It often occurs through the establishment of subsidiaries of MNCs. In general, however, when non-resident entities fund expansion of the domestic capital stock, irrespective of whether it is direct or portfolio investment, the rise in external liabilities recorded as part of the economy's foreign-investment position in the international accounts must be matched by a rise in the level of productive plant, equipment and buildings recorded in the national capital stock data of the national accounts.

'Official' foreign investment consists of foreign purchases of financial liabilities of the government sector, excluding government business enterprises, as well as changes in the Reserve Bank's official reserve asset position. It includes not only bonds purchased by foreigners on first issue, but also bonds acquired in the secondary markets, as when Japanese investment houses buy large parcels of outstanding Australian government securities in order to diversify their international investment portfolios. This form of foreign investment has grown markedly in OECD economies in the wake of the financial liberalisation that occurred throughout the 1980s. At present there is no formal discriminatory policy against it.

The different forms of foreign investment in Australia can be depicted schematically thus:



At the macroeconomic level, total foreign investment in all forms, net of investment abroad by domestic enterprises, is reflected in the capital-account surpluses that match the regular current-account deficits of a host nation. What is generally not appreciated is that the more foreign investment an economy attracts, the higher its current-account deficit and foreign liabilities are likely to be.

With direct investment, MNCs often take real investment and funding decisions together. Thus, increased imports of capital goods recorded on the nation's trade account may be matched simultaneously by financial capital inflow from abroad recorded on the nation's international capital account to directly fund their purchase. However, MNCs sometimes fund the accumulation of capital through domestic borrowings.

Foreign Investment in Australia since World War II

Australia has persistently attracted foreign investment over more than two centuries, as has been reflected in its persistent current-account deficit. In absolute terms, the degree of foreign investment in Australia rose quite strongly from the early 1980s, mainly because of increases in portfolio investment. In the past few years, official flows have also risen sharply. Nonetheless, as a percentage of GDP, foreign investment flows were proportionately greater in earlier times, such as the late 19th century.²

Under the managed exchange-rate system that prevailed in the postwar years until 1983, foreign-investment flows were regulated mainly by the exchange controls administered by the Reserve Bank of Australia. No separate body oversaw direct foreign-investment proposals until the FIRB was formally established by the Fraser Government in 1976. However, before that time, and especially from the 1960s, federal governments of both political persuasions had intervened in an ad hoc way (see Kasper, 1984). Since 1976, the guidelines governing FIRB operations have been liberalised substantially as deregulation has proceeded in other spheres. Nonetheless, the power to deny direct foreign investment in Australia still rests with the Commonwealth treasurer and is exercised frequently, to Australia's ultimate cost.

The legislative backing for the Commonwealth government's foreign-investment policy is provided by the Foreign Acquisitions and Takeovers Act 1975, which permits the Commonwealth treasurer to disallow proposals that are contrary to the (undefined) 'national interest'. Foreign investment in the banking sector is also governed by the provisions of the Banking Act 1959 and the Banks (Shareholdings) Act 1972; and foreign investment in radio and television has to be consistent with the Broadcasting Act 1942. State government agencies also liaise with the FIRB and independently monitor foreign investment activity through separate official means, such as through Queensland's register of foreign ownership of land.

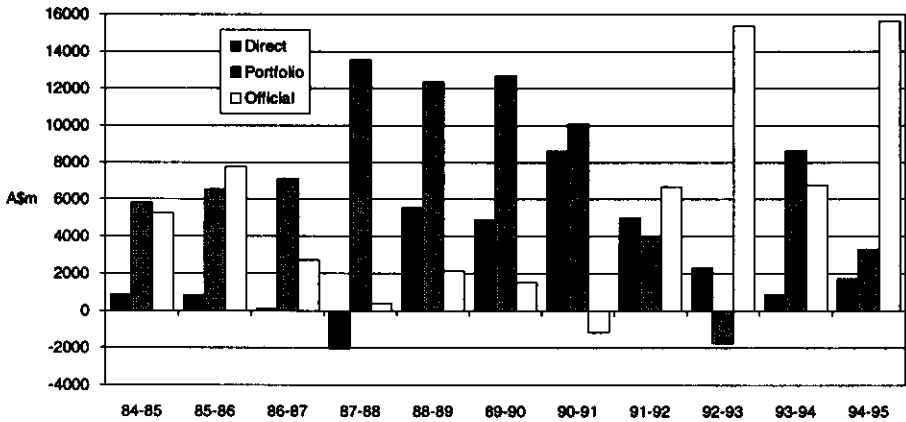
The relative shares of the main types of foreign investment over recent years are shown in Figure 1. Partly offsetting the higher level of foreign investment in Australia, from the mid-1980s Australian investment abroad, largely of a direct nature, rose sharply. This was a result of Australian-owned enterprises, in fields such as brewing

² See McLean (1989) for further historical details.

and transport, expanding their operations abroad. Since the main focus of this article is inward foreign investment and the policy that restricts it, outward foreign investment is not shown in Figure 1. Nonetheless, it is worth noting that the acquisition of foreign assets by residents is sometimes funded through offshore borrowings which are recorded as part of portfolio investment in Australia.

Figure 1

Direct, private portfolio and official foreign-investment flows to Australia, 1984-95



Source: Reserve Bank of Australia, *Bulletin*, December 1995, Table H.2.

According to FIRB data, approved direct investment expenditure by foreign interests to establish new businesses or acquire existing firms amounted to \$24 billion in 1992-93 and \$23.5 billion in 1993-94. These FIRB data on expected foreign investment suggest that more direct foreign investment spending in Australia is actually decided abroad than the Australian Bureau of Statistics (ABS) foreign investment and international capital account data actually convey. For instance, the ABS (1995) measured capital account surpluses at \$15.9 billion in 1992-93 and \$16.3 billion in 1993-94, well below the FIRB estimates of expected foreign investment for those years.

However, in explaining the discrepancy between FIRB and ABS foreign investment data, it needs to be recognised that FIRB approvals can include projects which may never be undertaken or completed. At the same time, because the FIRB's expected direct foreign-investment data have persistently exceeded measured capital account surpluses over recent years, it seems unlikely that foreign investment in the form of external borrowing is directly funding household consumption expenditure in Australia, even though many commentators believe it is.

Economic Benefits of Foreign Investment

As a general principle, the greater the international trade in assets, the greater are the potential economic welfare gains. Although it is widely accepted that the liberalisation of international trade in goods and services enhances welfare, the similar gains arising from international trade in assets, both financial and real, are often, and inconsistently, ignored or denied.

Widespread concern about private foreign investment in Australia relates mainly to direct investment, and specifically to the loss of control of established domestic firms through foreign takeovers or the acquisition of real estate by non-residents. Accordingly, whenever this happens on a large scale it is often said that Australia is 'selling off the farm'. Yet despite these nationalistic concerns, economic benefits always accrue to the residents who choose to dispose of their assets to foreigners. In particular, opponents of foreign investment generally fail to appreciate that whenever domestic financial or real assets are purchased by non-residents, the amount of funds available to residents for additional spending is thereby supplemented.

Moreover, when foreigners buy existing Australian assets at higher prices than residents would be willing to pay, the Australian sellers of those assets make capital gains that they otherwise would not have made. The proceeds of the sale of assets may then be used to create new domestic assets, to be spent on consumption, or even to acquire new foreign assets. Such economic gains suggest that, as a nation, Australia may be better off allowing foreigners greater freedom to purchase domestic assets, including all forms of real estate. Sales of domestic assets by residents to foreigners actually enable residents to upgrade the existing capital stock or spend the proceeds acquiring something else entirely.

The economic impact of direct foreign investment and MNCs can be considered also at the enterprise or industry level. MNCs generate important economic benefits through the transfer of technology and product development, even though the domestic operations of MNCs are by definition foreign-owned and controlled. Furthermore, domestic employees of foreign-owned firms are exposed to international management practices; and the presence of new entrants in domestic markets stimulates imitative behaviour and acts as a spur to competition.³

Foreign capital inflow in aggregate also improves the nation's economic welfare to the extent that it frees Australia from the constraint of its own saving level. The amount of additional economic activity in a range of domestic activities would not be as great and overall GDP growth would be lower without the benefit of net foreign investment. Without foreign capital inflow, long-term interest rates would also probably be higher, as the economy would then be totally reliant on domestic sources of funds to finance its investment requirements. So if greater direct or portfolio foreign investment is forthcoming, then the higher associated current-account deficits should be welcome, for macroeconomic reasons, in addition to the microeconomic ones outlined above.

³ See Caves (1971), Hymer (1976), Dunning (1988) and Markusen (1995) for more formal treatment of the microeconomic theory of direct foreign investment.

In general, foreign purchases of Australian assets can generate more investment expenditure in Australia. Moreover, the funds available for domestic investment are also supplemented when real domestic assets like property are bought by foreigners. Greater foreign investment makes possible faster growth in the size of the nation's capital stock; this creates additional employment and improves the overall productivity of the workforce. In turn, the higher labour productivity also allows domestic wages to be higher than would be possible with the smaller capital stock that would result from reliance on domestic saving alone.

The Economic Cost of Australia's Foreign Investment Policy

Just how much is Australia losing in an economic welfare sense because of the existing Commonwealth regulations or because foreign-investment proposals have been rejected by the Commonwealth treasurer for the sake of the nebulous 'national interest'? The size of any such economic welfare loss is difficult to quantify with any precision. Nonetheless, the data on total foreign investment proposals published by the FIRB over recent years are a starting point, especially as these data provide a rough basis for estimating how much foreign capital Australia has forgone as a consequence of the current foreign-investment policy.

Table 1

Foreign-investment proposals to the FIRB by number and total expected expenditure, 1990-94

<i>Type of proposal</i>	<i>1990-91</i>		<i>1991-92</i>		<i>1992-93</i>		<i>1993-94</i>	
	<i>No.</i>	<i>\$bn</i>	<i>No.</i>	<i>\$bn</i>	<i>No.</i>	<i>\$bn</i>	<i>No.</i>	<i>\$bn</i>
Approved	928	12.7	1048	11.98	1334	18.9	1734	16.3
Approved conditionally	1597	7.6	1933	3.85	2268	5.1	3085	7.2
Total approved	2525	20.2	2981	15.8	3602	24.0	4819	23.5
Rejected	69	1.9	66	1.81	58	0.1	84	0.1
Total decided	2594	22.2	3047	17.63	3660	24.1	4903	23.6
Withdrawn	235	?	227	?	165	?	384	?
Total considered	2829		3274		3825		5287	

Source: FIRB (various years).

Table 1 shows that, between 1990-91 and 1993-94, the number of foreign investment proposals approved by the FIRB far exceeded rejections. But over that period around \$4 billion of foreign capital was explicitly disallowed. This figure is a direct measure of the additional investment Australia could otherwise have enjoyed. Foreign-investment policy as implemented over recent years deprived Australia of the opportunity to accumulate \$4 billion of additional capital, through either the creation of new assets or the acquisition of existing ones.

Yet this figure underestimates the true amount of additional investment lost under the existing restrictions, for several reasons. The number of proposals withdrawn far exceeds the number disallowed. Withdrawals occur when foreign-investment proposals are seen to be inconsistent with existing policy and hence likely to be rejected outright by the FIRB. If it is assumed that the average annual dollar value of each withdrawn foreign-investment proposal put to the FIRB between 1990-91 and 1993-94 was of similar magnitude to the average annual value of each unconditionally approved proposal, then Australia's foreign investment policy cost the nation a further \$6 billion in unrealised foreign investment over the period. Adding this amount to the value of foreign-investment proposals actually rejected by the FIRB gives a total of \$10 billion in potential lost development capital. As well, the salaries of the executive of the FIRB and of the 20 or so Commonwealth treasury officers engaged full-time on foreign-investment matters cost between \$1m and \$2m annually; this too should be taken into account in estimating the total economic welfare cost of existing policy.

Admittedly, the assumption underlying the costing of the economic welfare loss due to the number of proposals withdrawn from FIRB consideration is somewhat arbitrary; and some disallowed investment proposals may be approved subsequently in revised form. Ideally, of course, the FIRB should itself be providing data on the value of foreign investment that is lost as an explicit result of present policy. Nonetheless, even if actual FIRB data on the actual value of withdrawn proposals put by foreign interests were published by the FIRB in its annual reports, such values would still tend to understate the full cost of the existing foreign-investment restrictions, since proposals classified as conditionally approved may actually be trimmed versions of earlier proposals. Finally, the value of proposals actually withdrawn would not account for those proposals that foreigners would have submitted had they stood a chance of acquiring assets in the heavily protected media, real estate and transport sectors of the economy.

Conclusion

The existing anomaly between Australia's policy toward international trade in goods and services and its policy toward international trade in assets — liberal in the former but restrictive in the latter — is likely to become more internationally apparent in the near future. The OECD has long been advocating freer capital movements through the Code of Liberalisation of Capital Movements, first drafted in the early 1960s; and a new OECD agreement on global capital flows proposes that foreign investment be treated no differently from domestic investment. Not only is Australia's existing foreign investment policy at odds with the OECD's view of the benefits of freer capital movements, it is also inconsistent with the 1994 APEC Bogor declaration, which advocated 'free and open investment in the region' on the same principle as contained in the OECD code, namely, that foreign and local investors be treated equally.⁴

The point often missed by those suspicious of foreign capital, and unrecognised by present foreign-investment guidelines, is that foreign investment, irrespective of

⁴ See Bureau of Industry Economics (1995) for related discussion.

whether it creates new assets or is used to purchase existing ones, including residential real estate, facilitates extra economic activity in Australia. Foreign investment can be interpreted as a measure of how much money foreigners are willing to invest in the economy's future and hence of how much additional domestic investment, production and consumption is achievable.

This brings to mind an astute comment made by the 19th-century English economist, Walter Bagehot, which is as relevant and true today about the significance of foreign money as it was originally meant to be about domestic money:

We have entirely lost the idea that any undertaking likely to pay, and seen to be likely, can perish for want of money; yet no idea was more familiar to our ancestors, or is more common now in most countries. (1873:7)

Surprisingly, Bagehot's basic point is apparently still not fully appreciated by the Commonwealth treasury and the FIRB. As a result, the foreign investment restrictions in place continue to cost Australia billions in lost investments.

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