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## C Foreign direct investment

There is a range of barriers to foreign direct investment (FDI) 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 type of barrier and considers possible reforms to the Australian and New Zealand FDI policy regimes that would promote trans-Tasman and broader integration. The second type of barrier is discussed in supplementary papers F and G, and the third type in chapter 2.

### Box C.1 Foreign direct investment

Foreign direct investment (FDI) 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 a different economy.

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.

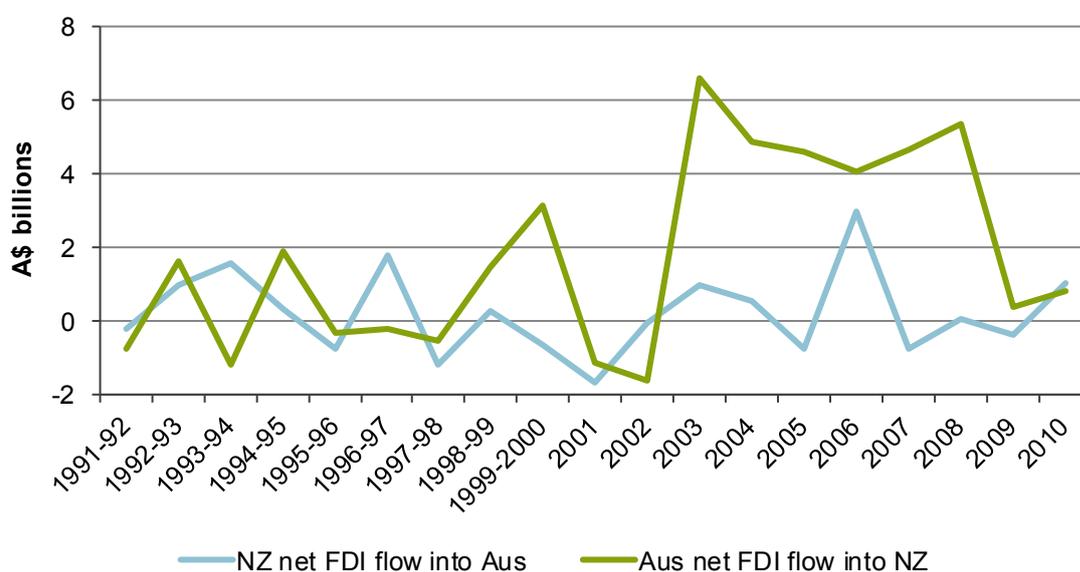
*Source:* OECD (2008).

## C.1 Trans-Tasman direct investment

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

Between 1991-92 and 2010, the flow of New Zealand FDI into Australia alternated between periods of net inflows and net outflows while the total stock of New Zealand FDI in Australia fluctuated between A\$6 billion and A\$11 billion (figures C.1 and C.2). In the other direction, the flow of Australian FDI into New Zealand alternated between net inflows and outflows from 1991-92 to 2002. From 2003 to 2010, net inflows of Australian FDI into New Zealand 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).

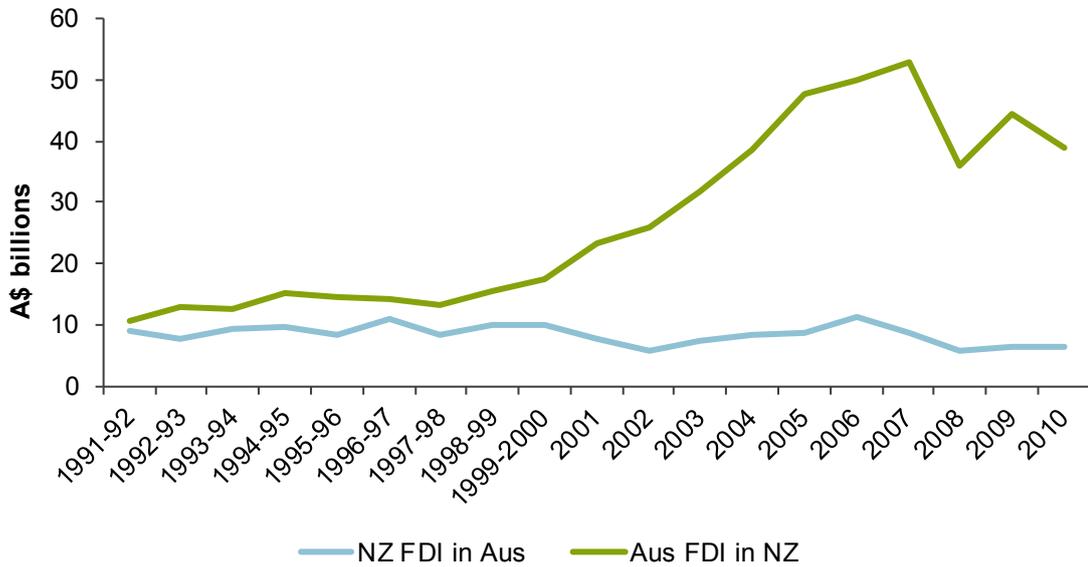
Figure C.1 **Trans-Tasman net flows of foreign direct investment, 1991-2010, 2010 prices<sup>a</sup>**



<sup>a</sup> Net flows of foreign direct investment 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 foreign direct investment, 1991-2010, 2010 prices<sup>a,b</sup>**

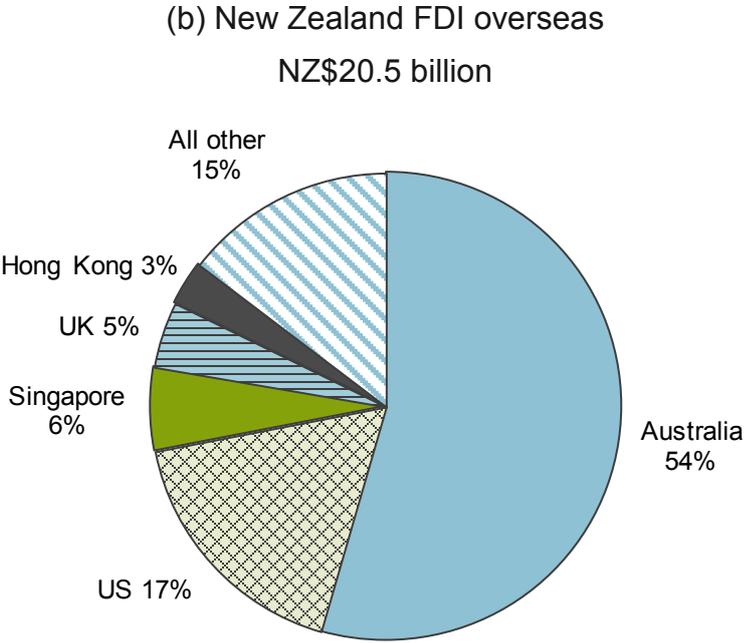
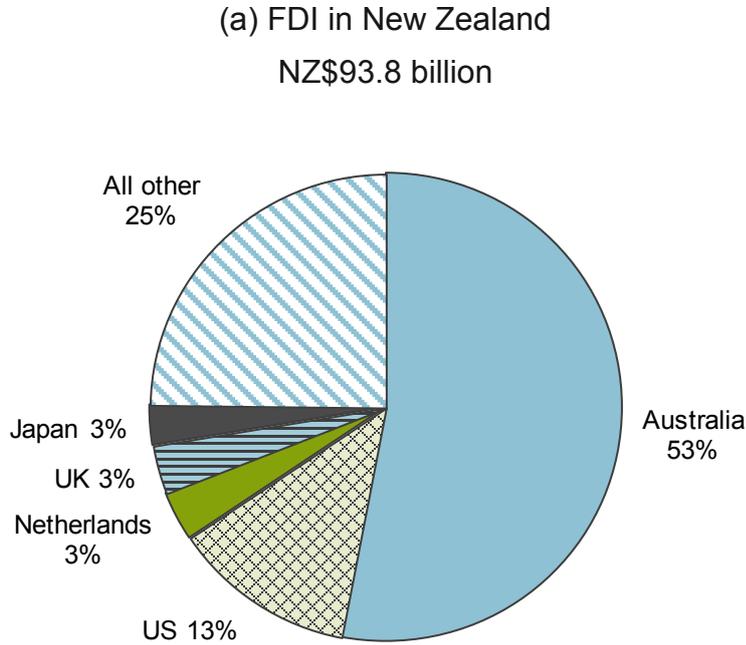


<sup>a</sup> The 'stock' of foreign direct investment (FDI) is a measure of all such investment at a point in time. Data from 1991-92 to 1999-2000 are for financial years ending 30 June. Data from 2001 onwards are for calendar years ending 31 December. <sup>b</sup> The level of stock can vary with FDI flows as well as changes in asset prices and exchange rates.

Sources: ABS (2001, 2012).

In 2010, Australia accounted for around 53 percent of all FDI in New Zealand (about NZ\$49.7 billion from a total of NZ\$93.8 billion) (figure C.3a). This represented around 11 percent of Australia's outward 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 outward FDI (figure C.3b).

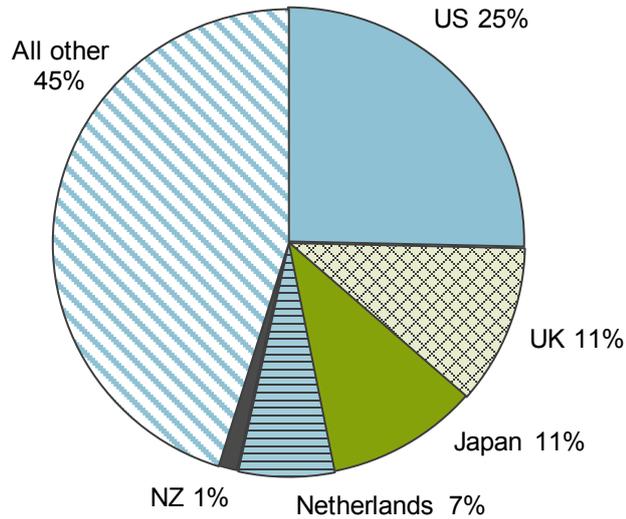
Figure C.3 **New Zealand stock of foreign direct investment, by country, 2010<sup>a</sup>**



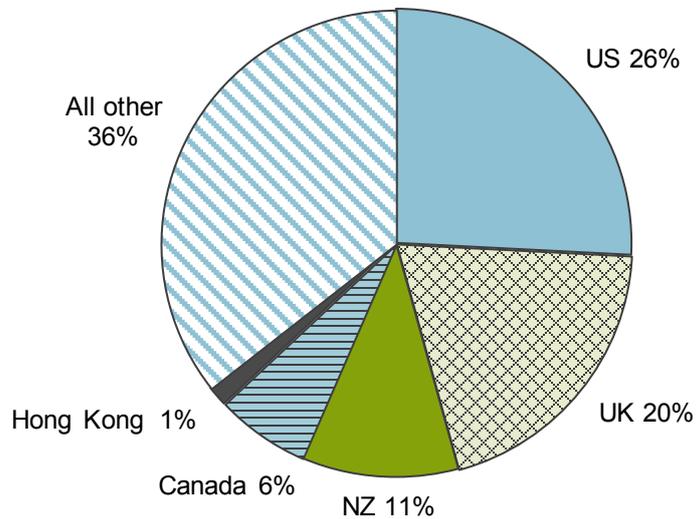
<sup>a</sup> Data are as at 31 March 2010. Rounded to the nearest percentage point.  
Source: Statistics New Zealand (2011).

Figure C.4 Australian stock of foreign direct investment, by country, 2010<sup>a</sup>

(a) FDI in Australia  
A\$473.7 billion



(b) Australian FDI overseas  
A\$361.8 billion



<sup>a</sup> Data are as at 31 December 2010. Rounded to the nearest percentage point.

Source: ABS (2012).

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## C.2 Current restrictions on foreign direct investment

While the Australian and New Zealand Governments acknowledge the positive contribution that foreign investment makes to the wellbeing of their citizens, they continue to place restrictions on such investment (FIRB 2012; New Zealand 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 direct 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' areas) 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 annually). 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 annually). 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 New Zealand–China FTA.<sup>1</sup>
- 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

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<sup>1</sup> 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 New Zealand-China FTA (which does contain an enforcement mechanism).

ensures that each country extends to the other the benefit of any additional liberalisation undertaken as a result of future agreements with other countries.

- 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) provided such treatment is not 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 restrictions such as equity limits.

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

<i>Type</i>	<i>Description</i>	<i>Trans-Tasman modifications</i>
Screening	A test of whether proposals are ‘contrary to the national interest’ is applied to foreigners acquiring an interest of 15 percent or more in a business or corporation valued above A\$244 million.	Threshold of A\$1062 million for New Zealand (and US) investors if a ‘sensitive’ sector is not involved. <sup>a,b</sup>
	<p>Additional screening applies to foreign investment proposals in ‘sensitive’ sectors, including for:</p> <ul style="list-style-type: none"> <li>• non-residential commercial real estate valued above A\$53 million</li> <li>• residential real estate</li> <li>• purchases of 5 percent or more of a media firm</li> <li>• new entrants or existing carriers in the telecommunications sector</li> <li>• new entrants or existing banks in the finance sector (the investment must be consistent with the <i>Banking Act 1959</i> (Cwlth), the <i>Financial Sector (Shareholdings) Act 1998</i> (Cwlth), banking policy, and Australian prudential requirements</li> <li>• domestic and international civil aviation</li> <li>• ships registered in Australia</li> <li>• Australian airports.</li> </ul> <p>A ‘national interest’ test is also applied to all direct investments by foreign governments and their related entities (such as sovereign wealth funds and state owned enterprises).</p>	<p>Threshold of A\$1062 million for New Zealand (and US) investors.<sup>b</sup></p> <p>New Zealand citizens exempt.</p> <p>None</p> <p>None</p> <p>None</p> <p>None</p> <p>None</p> <p>None</p> <p>None</p> <p>None</p>

(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, aggregate ownership by foreign airlines is limited to 35 percent. Criteria relating to the nationality of board members and operational location must also be satisfied.	None
	Total foreign investment in Telstra is limited to 35 percent (5 percent for individual foreign investors). Criteria relating to the nationality of board members and operational location must also be satisfied.	None
	Total foreign investment in Australian airports offered for sale by Commonwealth is limited to 49 percent (additional limits on cross ownership with airlines and other airports).	None
	Ships registered in Australia must be majority Australian-owned.	None

<sup>a</sup> Australian sensitive sectors include finance, media, telecommunications, transport, encryption services and uranium extraction. <sup>b</sup> 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 direct investment restrictions**

Type	Description	Trans-Tasman modifications
Screening	A 'character, business acumen and level of financial commitment' test is applied to foreigners acquiring an interest of 25 percent 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. <sup>a</sup>
	A 'likely to yield net benefits that are substantial and identifiable' test is applied to foreigners acquiring any business that holds 'sensitive' land, farm land or fishing rights.	None
Foreign equity limits	Total foreign acquisition of 10 percent or more of Chorus (previously part of Telecom New Zealand) voting shares requires approval by New Zealand shareholders and the Chorus board.	None
	Any foreign investor wishing to acquire 49.9 percent or more of Chorus voting shares must obtain separate government approval.	None
	Total foreign acquisition of Air New Zealand shares and single acquisition of more than 10 percent of voting rights must be approved by New Zealand shareholders. No more than 49 percent of the carrier can be foreign owned.	None

<sup>a</sup> The amount is for 2012 and is indexed annually by the GDP implicit price deflator.

Sources: Chorus (2012); Heatley and Howell (2010); New Zealand Treasury (2012).

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Participants expressed a range of views on the FDI arrangements that currently regulate trans-Tasman investment (box C.2).

### **Box C.2 Participant views on foreign direct investment restrictions**

Lloyd (sub. 5) argued for the removal of remaining trans-Tasman FDI restrictions, but noted 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 Tirenī/Treaty of Waitangi Partners (sub. 20) indicated 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.

Mahony and Sadleir (sub. 28) argued 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) asserted 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.

Qantas (sub. DR117) supported the removal of restrictions on foreign ownership (including for Single Aviation Market carriers). It argued this would bring Australia's aviation industry into line with other industries and improve its ability to compete. It would also improve opportunities to participate in cross-border industry consolidation and strategic alliances.

The Australian Council of Trade Unions (ACTU) and the New Zealand Council of Trade Unions Te Kauae Kaimahi (NZCTU) (sub. DR118) opposed any lessening of trans-Tasman restrictions on foreign investment, including the implementation of the Investment Protocol. They argued that trans-Tasman investment had grown substantially without the Protocol and that the current FDI regimes were not as restrictive as suggested by the OECD FDI Regulatory Restrictiveness Index (box C.3). They stated that both countries have 'understandable sensitivities' in certain areas which they have the right to maintain.

The ACTU and NZCTU supported tighter restrictions on FDI generally. They argued that regulation could be used to ensure that spillover benefits of FDI accrued to the host country, and to manage the damaging effects of FDI (such as the destabilising effects from the movement of funds controlled by foreign direct investors).

The ACTU and NZCTU opposed making investments in water rights subject to the Protocol. They noted that water is not only important economically, but is also vital in daily life and has environmental and cultural significance. They argued that the Protocol has a commercial focus and rules out a range of measures that may be required to protect important environmental assets.

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## C.3 How restrictive are the foreign direct investment regimes?

Determining the restrictiveness of an FDI regime is difficult as it requires an estimation of the counterfactual — how much FDI would there be in the absence of the restrictions? Analysis must rely on measures of comparative restrictiveness or estimates of how much investment has been deterred. There is some literature on how restrictive the Australian and New Zealand FDI regimes may be in general. However, there is little evidence on the specific impact on trans-Tasman investment flows.<sup>2</sup> This section examines the restrictiveness of Australia's and New Zealand's FDI policy regimes in general, before considering the extent to which the CER Investment Protocol is likely to liberalise trans-Tasman FDI.

One attempt to quantify and compare investment barriers is the Foreign Direct Investment Regulatory Restrictiveness Index compiled by the OECD (box C.3). The index indicates that Australia and New Zealand have more restrictive investment regimes than many other countries. 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 Australian 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 on specific companies (such as airlines and telecommunications carriers) and specific infrastructure (such as airports). New Zealand's screening regime was rated as substantially more restrictive than Australia's.<sup>3</sup>

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<sup>2</sup> On paper, trans-Tasman direct investments face the same restrictions as FDI from other countries (including the same screening thresholds and equity limits). However, in practice, it is likely that the degree of restrictiveness on trans-Tasman flows is less than for flows from many other countries. For example, it is probable that trans-Tasman investments are less likely to be rejected on national security grounds or due to concerns about non-commercial investment by state owned enterprises. These issues are discussed further in section C.4.

<sup>3</sup> 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 more 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).

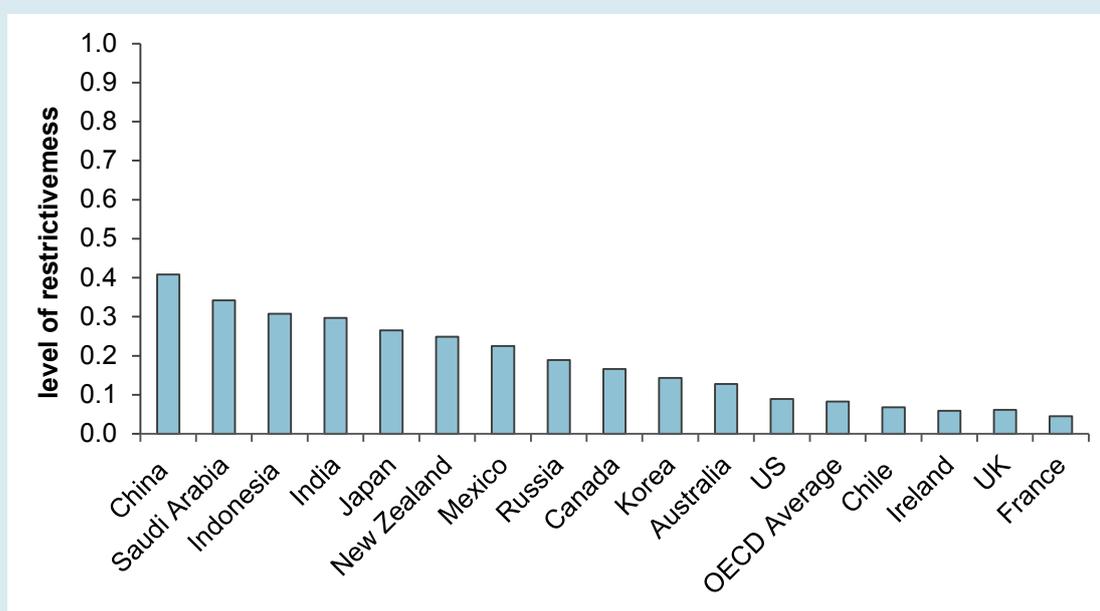
### Box C.3 **OECD ratings of foreign direct investment restrictiveness, by country, 2012**

The OECD Foreign Direct Investment (FDI) Regulatory Restrictiveness Index has been calculated for 55 OECD and non-OECD countries. It attempts to measure the deviation from 'national treatment' for foreign investors, where 0 represents full openness and 1 a prohibition on FDI (figure below).

The index number for a country is a weighted composite of ratings given to four categories of policies in 22 sectors of an economy. The categories of policies include foreign equity restrictions, investment screening processes, regulation of key personnel (such as nationality requirements for directors and executives) and other requirements imposed on foreign investors (such as local content rules).

While the index allows FDI regimes to be compared on a common basis across countries, it has a number of limitations. Ratings are based on stated government policies rather than their application in practice. Some barriers to FDI are not measured (for example, state ownership in key sectors). There is also a degree of subjectivity in how ratings are assigned to individual policies. The OECD cautions 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 and that any gains from its removal would likely be small (Daley, McGannon and Ginnivan 2012). As evidence of this, the report pointed to data showing that the vast majority of foreign investment applications in Australia are approved (table C.3).

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

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

<sup>a</sup> 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 one was a business proposal. The rejected business proposal — the A\$8.4 billion takeover of the Australian Securities Exchange by the Singapore Stock Exchange — was the first business application rejected since the attempted takeover of Woodside Petroleum by Shell Australia in 2001. The Grattan Institute also noted that Australia's inflows and 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 Foreign direct investment as a percent of GDP, 2008–11<sup>a</sup>**

	<i>Inflows</i>				<i>Stock</i>			
	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

<sup>a</sup> 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 changes in asset prices and exchange rates. **na** Data not available.

*Source:* OECD (2012b).

Similarly, the New Zealand Treasury — in a 2009 review of policy settings — argued that while New Zealand's FDI regime was rated as more restrictive than

other countries, barriers were relatively low in practice (although, as discussed below, the report noted barriers were still unduly restrictive) (New Zealand Treasury 2009a). As evidence of this, the report pointed to data showing that from 2002 to 2008, only 33 FDI applications were declined while 1050 were consented (a rejection rate of 3.0 percent) (table C.5). No business-only applications had been rejected since 1984. The New Zealand Treasury 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 of FDI have varied above and below the OECD average) (table C.4).

**Table C.5 Investment applications from all countries, New Zealand, 2002–2008<sup>a</sup>**

	<i>Total</i>	<i>Fishing quota</i>	<i>Business</i>	<i>Business and sensitive land</i>	<i>Sensitive land</i>
Consented	1 050	1	127	56	866
Declined	33	0	0	2	31
Other <sup>b</sup>	526	na	na	na	na

<sup>a</sup> For the period 26 August 2002 to 25 August 2008. <sup>b</sup> 526 applications were processed, but involved exemptions, variations to existing consents, consent if proceeds, no consent required or were applications that were either withdrawn by the applicant or lapsed. **na** Data not available.

Source: New Zealand 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 not made because of the presence of the screening regimes.

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

Third, applications can be made and then withdrawn before being assessed. For example, in Australia in 2010–11, 390 applications (around 3.6 percent of all 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, 136 of the 526 applications in the 'other' category in table C.5 (8.5 percent of all applications) were voluntarily withdrawn by applicants or lapsed by the Regulator due to the applicant failing to provide the information necessary to make a final assessment (Overseas Investment Office, pers. comm.).

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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).

Some literature argues that screening tests can restrict FDI by imposing costs and increasing uncertainty for investors. In a 2008 review of Australia's foreign investment regime, economic consultancy ITS Global argued that foreign investors faced significant uncertainty due to the ambiguity around the definition of the Australian 'national interest' (ITS Global 2008). The review noted that the *Foreign Acquisitions and Takeovers Act 1975* (Cwlth) does not define the national interest and the Australian Government's Foreign Investment Policy merely states that the Government determines what is contrary to the national interest by 'having regard to the widely held community concerns of Australians'. ITS Global argued that the legislative intent seemed to be to leave considerable discretion with the Government.

Analysts have also argued that the New Zealand screening regime 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, most of which relates to the treatment of 'sensitive' land. 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. Further, uncertainty arises because key terms such as 'strategically important infrastructure' are not defined in the Act. As a result, the outcome of past applications may be a poor guide to the outcome of future applications. The resulting uncertainty 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. Possible improvements to the regime have been suggested, including the use of a cost-benefit assessment framework which would remove the discretionary weighting of factors and allow the consideration of other costs and benefits relevant to the national interest (Heatley and Howell 2010).

A 2009 New Zealand Treasury review of the country's FDI screening regime found that it was likely to be deterring foreign investment. The report stated:

There are a number of examples of investors who have been frustrated by the complexity of the regime and the 'draconian' requirements it imposes. In some cases experience with the screening regime is completely deterring investors from investing

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in New Zealand, and some are even actively discouraging other investors from considering investing in New Zealand. (New Zealand Treasury 2009b, p.25)

In particular, the report found that for ‘sensitive’ land screening (which accounted for around 88 percent of FDI applications decided):

- complexity and cost had increased since 2005 (when the scope of the *Overseas Investment Act 2005* was widened and the number of criteria used to assess land applications increased from 11 to 27)
- there were high levels of uncertainty due to wide Ministerial discretion in the weighting of criteria used to assess investments and the level of benefits that must be demonstrated by the investor
- conditions imposed on approved proposals were costly to comply with and tended to go well above what a domestic investor was required to do (New Zealand Treasury 2009b).

The Treasury report put forward a range of options for simplifying sensitive land screening and reducing the number of investments subject to the *Overseas Investment Act 2005*. Broadly, these options focused on:

- tightening the scope of ‘sensitive’ land to avoid screening investments that may not actually be ‘sensitive’ (for example, by increasing the land area thresholds and removing certain types of land from the ‘sensitive’ definition)
- modifying the standards test applied to foreign investors to ensure they are not subject to a higher standard than domestic investors (for example, by simplifying and narrowing the benefit tests) (New Zealand Treasury 2009b).

Amendments to the New Zealand screening regime made in response to the Treasury review included the introduction of two additional criteria into the benefit test in the *Overseas Investment Regulations 2005* — an ‘economic interest’ and a ‘mitigating’ criteria. The New Zealand Overseas Investment Office is required to consider these additional criteria when assessing foreign investment proposals in the land-based primary sector (English 2012).

On balance, there is evidence that Australia and New Zealand impose relatively restrictive regimes on FDI inflows in general compared to many countries, although the level of restrictiveness is likely to be less than the OECD ratings suggest. Restrictiveness is driven to a large extent by screening processes in both countries, in particular, for ‘sensitive’ land in New Zealand and ‘sensitive’ sectors in Australia.

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## The effect of the CER Investment Protocol on restrictions

The degree of liberalisation of trans-Tasman investment that will result from implementation of the Protocol is expected to be small. Screening thresholds for Australian and New Zealand investors will be raised not removed, both countries have excluded a range of ‘sensitive’ areas from the higher thresholds, and foreign equity limits on specific businesses and types of infrastructure will remain (tables C.1 and C.2).

For Australian investors in New Zealand, the higher thresholds will reduce the number of business investment proposals subject to New Zealand screening. An analysis of business applications lodged by Australian investors in New Zealand between January 2006 and July 2010 found that 90 of the 140 applications made during that time would have been exempt from screening under the higher thresholds (a 64 percent reduction over the period) (DFD 2012).

However, business applications are likely to be a small proportion of the total number of applications made by Australians looking to invest in New Zealand (MFAT 2011). For example, between 2002 and 2008 business applications made up only 12 percent of all FDI applications (from all countries) consented by New Zealand regulators (table C.5). The other 88 percent were for ‘sensitive’ land or business applications that included a component of ‘sensitive’ land and these would not be exempt from screening under the Protocol.

For New Zealand investors in Australia, the higher thresholds under the Protocol should, in principle, reduce the number of New Zealand business applications screened. However, given the relatively low level of FDI flowing from New Zealand to Australia in recent years, there are likely to be few New Zealand investments valued between A\$244 million and A\$1062 million that would benefit in practice (Statistics New Zealand 2011).

The Protocol is also likely to reduce uncertainty to some degree for investors from both countries. This may come from two sources — higher thresholds will remove uncertainty for investment proposals that will no longer be screened, and the Protocol’s investment framework may reduce uncertainty by clarifying investors’ rights. As discussed in the next section, quantifying these effects is a difficult and sometimes contentious process.

The Protocol is not expected to impose obligations on Australia or New Zealand to extend preferential arrangements to any other country. Based on the Commissions’ reading of Australia’s and New Zealand’s bilateral and regional trade agreements (BRTAs) and bilateral investment treaties (BITs), it appears that the agreements either do not have an MFN clause that could require this or, where

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they do, existing agreements and extensions to those agreements (such as the ANZCERTA) are exempt.

## **C.4 What are the costs and benefits of existing restrictions on trans-Tasman direct investment?**

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 are less clear.

### **Costs**

There are several types of economic costs associated with restrictions on foreign investment. First, restrictions (such as screening regimes and equity limits) entail administrative costs to governments and compliance costs for firms. They also increase uncertainty for investors. Second, restrictions may deter foreign investment and result in higher cost domestic capital being used in its place, increasing operating costs for business and lowering overall investment in an economy. Third, restrictions may deter FDI that would have brought with it increased competition and 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 service sectors affected, foreign investment restrictions can result in a range of additional economic costs including higher prices (through less competition) and less diversity and innovation (Hardin and Holmes 1997).

International research supports the idea that restrictions on FDI impose a range of economic costs on the recipient economy. Restrictions in specific sectors such as telecommunications have been found to be associated with the reduced spread of telecommunications technology and services (Warren 2000), higher prices (Warren 2000) and reduced trade and competition in that sector (OECD 2008). At the economy-wide level, higher foreign investment barriers are associated with lower levels of trade and investment (OECD 2003 and 2006) and reduced national incomes (OECD 2005).

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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 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 New Zealand Treasury estimates the average cost of a business 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 (depending on the complexity of the application) (New Zealand Treasury 2009b). Business applications that include some 'sensitive' land must comply with the land application processes and so incur higher costs.

Time delays incurred in preparing an application and waiting for the outcome also increase compliance costs for investors. For example, the New Zealand Treasury estimates that hedging a NZ\$100m investment (the minimum business investment that would be screened) for two months would cost an investor around NZ\$650 000, increasing to around NZ\$2 million for six months. The New Zealand Treasury reported 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. (New Zealand Treasury 2009b). The Commissions are unaware of estimates of compliance costs faced by New Zealand investors under the Australian screening regime.

Estimating the quantity of trans-Tasman investment deterred by existing restrictions and the resultant economic costs to Australia and New Zealand is a 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).

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#### Box C.4 **Measuring the economic costs of foreign direct investment restrictions**

Various approaches have been used to measure the costs imposed by foreign direct investment (FDI) regimes.

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 thresholds under AUSFTA would reduce the Australian risk premium for US investors. They then modelled the effect of this on investment flows and economic growth. They 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 Australian 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 related to transaction costs.

In a 2010 study prepared for the Australian Department of Foreign Affairs and Trade — *Quantifying the benefits of 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’ and mode 3 ‘commercial presence’ (CIE 2010). The CIE modelled the liberalisation of commercial presence as the removal of FDI regimes (including screening processes, equity limits of foreign ownership and other ongoing operational limits on 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 host country markets.

The CIE found that under global ‘overnight’ liberalisation of mode 1 and 3 barriers, developing countries, on average, experienced a 0.9 percent gain in real GDP over 2011 to 2025, while developed countries experienced a gain of 0.2 percent. Around 89 percent of the gains by developing countries and 52 percent of the gains by developed countries came from liberalisation of mode 3 FDI barriers to commercial presence (CIE 2010).

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

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This modelling is more experimental than the modelling of other aspects of trans-Tasman integration undertaken for this study 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 services trade is discussed in detail in supplementary paper E.

The modelling suggests that New Zealand bears a relatively higher cost from restricting trans-Tasman investment flows than Australia (box C.5). The cost to New Zealand of current restrictions on trans-Tasman direct investment in services is estimated to be between 0.06 and 0.08 percent of real gross national product (GNP). These costs for New Zealand are projected because Australia provides a large amount of FDI in New Zealand services (for example, approximately 90 percent of the banking sector and a large share of retail) (figure C.3).

The modelling suggests the corresponding cost to Australia of its limitations on trans-Tasman FDI in services is likely to be negligible (rounding to zero in real GNP terms) (box C.5). The relatively insignificant impact for Australia is because most foreign investment in Australian services is held by countries other than New Zealand (figure C.3).

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. However, the FDI regimes restrict direct investment flows from all sources and this imposes additional costs on the two economies.

### Box C.5 Modelling a reduction in trans-Tasman barriers to foreign direct investment for services

Various types of foreign direct investment (FDI) barriers can impede trade in services. For trade via 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). Since these barriers are not source specific, they were reduced to account for the high level of trans-Tasman integration. 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 0.9 percent premiums on returns to foreign capital on average across services for both Australia and New Zealand (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 compliance costs and 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**

	<i>Rents on foreign capital</i>		<i>Cost-increasing effects</i>	
	<i>Australia</i>	<i>New Zealand</i>	<i>Australia</i>	<i>New Zealand</i>
	%	%	%	%
<b>Trans-Tasman barriers</b>				
Barriers to services <sup>a</sup>	0.9	0.9	2.4	0.9
Barriers to communications	0.5	0.5	4.5	3.1
<b>Barriers with all partners</b>				
Barriers to communications <sup>b</sup>	0.9	1.3	1.1	1.2

<sup>a</sup> Weighted average of barriers for all services industries. <sup>b</sup> Weighted average of barriers for all foreign countries. The weighted average of barriers for all foreign countries in the communications sector is larger than the equivalent trans-Tasman barriers because trans-Tasman barriers were reduced to account for the high-level of trans-Tasman integration.

Sources: CIE (2010); supplementary paper E.

(Continued next page)

### Box C.5 (continued)

Reducing barriers to commercial presence across the Australian and New Zealand services sectors could increase New Zealand real GNP by 0.08 percent if capital is assumed to be highly substitutable (table below). The gains in New Zealand occur because Australian-owned capital flows to New Zealand where it is more productive. The subsequent reduction in capital in Australia is partially offset by an inflow of capital owned by the Rest of the World and New Zealand into Australia. When the increase in returns to Australian capital in New Zealand are considered, Australian GNP (which includes income from Australian-owned capital) does not change.

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 no observable benefit for Australia, and small benefits to New Zealand. Australian telecommunications firms increase their investment in New Zealand, due to the larger increase in returns to capital in New Zealand (particularly as a result of the removal of cost-escalating barriers). This allows New Zealand's capital stock to expand, and increases the productivity and returns to New Zealand labour.

Removing barriers to all foreign investment in the communication services industry produces larger GNP gains in 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**

	<i>Australia</i> % change	<i>New Zealand</i> % change
<b>Preferential</b>		
Remove trans-Tasman barriers to FDI — all services	–	0.06–0.08
Remove trans-Tasman barriers to FDI — communications <sup>a</sup>	–	0.01
<b>Non-preferential</b>		
Remove barriers to FDI all countries — communications	0.02–0.09	0.07–0.14

<sup>a</sup> Results for New Zealand did not vary under sensitivity analysis. – less than 0.005.

Source: supplementary paper E.

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 generates relatively small gains (no change in real GNP for Australia and an increase of 0.01 percent in New Zealand) while the

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non-preferential removal of FDI barriers for all countries generates significantly larger gains (an increase in real GNP of up to 0.09 percent for Australia and up to 0.14 percent in New Zealand) (box C.5).

Finally, it is likely that restricting trans-Tasman direct investment also imposes a range of wider economic costs on Australia and New Zealand (including less innovation and reduced transfers of skills and technology between the two economies). These wider costs are potentially significant in magnitude but difficult to estimate. One example of such costs was noted by Qantas (sub. DR117). Without specifying a magnitude, Qantas argued that current restrictions on foreign ownership reduced its capacity to compete and grow by limiting its ability to participate in cross-border industry consolidation and strategic alliances.

## **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. 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 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)

Submissions have raised other potential reasons for restricting FDI. Nga Hapū o Niu Tirenī/Treaty of Waitangi Partners (sub. 20) expressed concern about the impact of FDI on housing affordability and natural resource management in New Zealand. The Australian Council of Trade Unions and the New Zealand Council of Trade Unions Te Kauae Kaimahi (sub. DR118) argued that the two countries

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needed tighter restrictions on FDI to avoid damaging effects such as the negative impacts from expatriation of profits and the rapid movement of FDI. Other potential benefits raised in the literature include ensuring ongoing access to culturally significant land (New Zealand Treasury 2009a) and avoiding cultural dominance by foreign interests in local media (PC 2000).

FDI restrictions may be unnecessary where there are existing domestic regulations that are designed to achieve the same policy objectives. It could also be more transparent and cost effective to offer foreign investors the same ‘national treatment’ offered to a domestic investor. In addition, many of the potential benefits used to justify FDI restrictions can be better achieved by more directly targeting the desired outcome rather than the ownership of the investment.

The New Zealand Treasury stated that it would prefer to remove the country’s foreign screening regime altogether and rely on existing protections in other legislation to address community concerns about foreign investment in sensitive assets (New Zealand Treasury 2009c). Specifically, on foreign investment in ‘sensitive’ land, the Treasury stated that:

Concerns over land ownership seem more likely to be related to the use of the land, such as restricting walking access, rather than ownership per se. These concerns seem to be valid regardless of the nationality of the owner: there is no reason to think foreign owners would be any ‘worse’ at (say) allowing walking access than domestic owners. Therefore the most effective policy response would be to focus on (say) walking access directly and across the board. (New Zealand Treasury 2009a, p. 22).

Similarly, the Australian Commission (PC 2000) argued that concerns about cultural identity and the media are better addressed through policies that more directly target the objective — the creation and dissemination of culturally beneficial material — rather than by limiting foreign investment in the media and broadcasting sectors. The report noted that domestic Australian policies (such as local content quotas that applied to all television broadcasters regardless of ownership) already existed to that end (although a recommendation was made to review their use).

There can be grounds for imposing restrictions that discriminate between domestic and foreign investment in some circumstances, but these are likely to apply to only a small number 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) requires greater scrutiny.

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

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economic interests of the recipient country. For example, the proposed 2001 takeover of Woodside Petroleum (the joint venturer in Australia's North West Shelf LNG project) by Shell Australia was rejected on the basis that it could have allowed Shell to restrict the development and export of Australian LNG in favour of LNG projects it controlled in other countries (Costello 2001).

## **Conclusion**

Existing restrictions on trans-Tasman direct investment are likely to impose (potentially significant) costs on the two countries. These include compliance costs on Australian and New Zealand investors and reduced incomes from deterred trans-Tasman investment (particularly for New Zealand). There are likely to be wider economic costs that are difficult to quantify (such as reduced innovation and transfers of skills and technology between the two countries). The costs to the two countries of restricting FDI inflows from all countries are expected to be substantially larger.

At the same time, the benefits of restricting trans-Tasman FDI are unclear. Some of the potential benefits (such as protecting national security or guarding against non-commercial investments by state-owned enterprises) are unlikely to apply to trans-Tasman investments. Other potential benefits (such as protecting the environment or guaranteeing access to sensitive lands) could be better achieved through the use of existing (non-discriminatory) domestic regulatory mechanisms.

On balance, there are likely to be gains available to Australia and New Zealand 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 direct investment**

The Australian Commission's report on the economic impacts of Australia's bilateral and regional trade agreements found some evidence that the inclusion of investment provisions in Australia's BRTAs had led to modest increases in investment and services trade (PC 2010). The OECD also found that investment provisions in recent preferential trade agreements were associated with increased trade and investment flows (OECD 2006).

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However, preferential deals require care and recognition that non-preferential approaches (such as unilateral liberalisation) may be more cost-effective and deliver greater benefits. The Australian Commission's report on BRTAs identified some issues to consider when considering preferential investment agreements to ensure that the costs and the benefits are fully accounted for (PC 2010).

- Does the agreement impose unnecessary costs? For example, the report argued that the investor-state dispute settlement provisions that Australia had agreed to in some BRTAs (granting foreign investors rights over and above those already provided by the Australian legal system) had risks and limited benefits.
- Does the agreement promote or inhibit further multilateral or unilateral liberalisation? For example, a preferential deal can facilitate more extensive liberalisation through the use of MFN clauses that require preferential arrangements to be extended more widely. Alternatively, they can inhibit further reform by encouraging countries to retain barriers for use as bargaining coin in later negotiations.

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, under certain conditions, the preferential removal of investment barriers can reduce welfare for the country making the policy change if the barriers are of the sort that generate economic rents, but not if they are of the type that increase costs (box C.6).

## **Costs and benefits of the CER Investment Protocol**

The Australian regulation impact statement (RIS) for the CER 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 'investor rights' framework (DFD 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.

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**Box C.6 Welfare effects of investment diversion caused by preferential liberalisation of investment barriers**

Where foreign direct investment (FDI) barriers impose real costs on foreign investors (such as equity limits and other ongoing operational requirements) preferential liberalisation will unambiguously save resources and increase overall welfare for the liberalising country. A reduction in cost-increasing barriers would reduce costs for investors from the partner country and generate gains to the host 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 generate welfare gains or, under certain conditions, welfare losses for the liberalising country. Screening can discourage new foreign entrants and allow incumbent foreign firms (and domestic firms) to earn rents (supplementary paper E). 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 create a range of benefits for the host country through increased investment and competition. However, by reducing the rents accruing to the incumbent foreign firms, new entrants can also reduce 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, earn smaller rents and pay 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 of FDI barriers is greater than the gains from increased investment, competition and other beneficial effects of new entrants, the host country could experience an overall welfare loss.

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\$2.7 million in application costs between January 2006 and July 2010.<sup>4</sup> The reduction in compliance costs for New Zealand investors is

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<sup>4</sup> Based on the Australian regulation impact statement estimate that 90 of the 140 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

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likely to be smaller (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 would 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 come from the increased competition, lower prices and higher incomes produced by an increase in trans-Tasman investment. The Australian Commission modelling suggests small income gains for New Zealand and negligible gains for Australia from partial trans-Tasman liberalisation (box C.5). The magnitude of wider economic benefits (for example, from increased innovation and transfers of skills and technology between the two economies) has not been estimated.

The Protocol could also impose some costs. The administrative costs of negotiating the agreement have already been incurred and implementation costs are likely to be minimal. The Protocol does not appear to impose costly administrative processes on parties (such as dispute resolution mechanisms). It does not appear to inhibit further unilateral or multilateral liberalisation by either country. In fact, it may encourage it through the 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.

The largest potential cost of implementing the Protocol is likely to come from investment diversion effects that result from the preferential lowering of screening barriers (box C.6). Investment diversion in the form of an increase in new trans-Tasman market entrants can drive down rents in previously uncompetitive markets and reduce the company taxes paid on those rents. However, this loss will be offset, to some extent, through other taxes paid by the new entrants. In addition (as discussed above), entry by new firms will generate various benefits for the liberalising country (such as lower prices for consumers from increased competition and greater transfers of technology and skills).

On balance, the modest benefits from implementing the Protocol are likely to outweigh (or at least offset) the costs for both countries. This outcome is reflected in the scenario modelled by the Australian Commission which shows that

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higher thresholds (DFD 2012) and the New Zealand Treasury estimate of the costs of a business application in New Zealand of \$30 000 (New Zealand Treasury 2009b).

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removing all trans-Tasman FDI barriers in service sectors can generate net gains for New Zealand while having a neutral impact on Australia (box C.5).

## **Conclusion**

While the CER Investment Protocol will have only small effects, it 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 a broader application of national treatment of investors from the other country. There may be legitimate reasons for not proceeding with this to the full extent (for example, 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 made 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 similar ‘low risk’ 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 follow the historical precedent of Australia and New Zealand liberalising trade restrictions with one another first and then with other countries.

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