23 August 2021

Manager
Policy Framework Unit, Foreign Investment Division
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Dear Sir/Madam

Evaluation of the 2021 foreign investment reforms

Please find following three reports from the United States Studies Centre that relate to the 2021 foreign investment reforms.

The reports address several of the consultation paper's questions, including the macroeconomic context for the reforms and the impact of the reforms on foreign investment uncertainty and foreign investment outcomes.

In particular, the reports note that foreign investment uncertainty, as measured by a foreign investment uncertainty index, was elevated in 2020, but has since moderated during the course of 2021. Inward foreign direct investment sourced from the United States has underperformed in recent years and Australia has underperformed peer economies and regions in attracting US direct investment, particularly since the passage of the US Tax Cuts and Jobs Act in 2017:

US Direct Investment Abroad (USD m)	2017	2018	2019	2020	% change 2019-20	% change 2017-20
All countries	6,097,690	5,792,290	5,907,424	6,152,301	4.1	0.9
Canada	371,274	373,604	404,589	422,160	4.3	13.7
Euro zone	3,654,095	3,413,031	3,501,659	3,660,470	4.5	0.2
United Kingdom	815,059	754,139	830,438	890,086	7.2	9.2
Asia and Pacific	938,668	879,968	941,721	969,647	3.0	3.3
New Zealand	12,384	11,379	11,869	12,903	8.7	4.2
Australia	169,749	166,269	161,200	163,466	1.4	-3.7

Source: US Bureau of Economic Analysis

The non-discriminatory application of Australia's foreign investment screening framework means that it is likely to capture cross-border transactions from traditional investment partners like the United States that would normally raise few policy concerns, particularly in relation to national security.

Yours sincerely

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UNITED STATES STUDIES CENTRE

AUSTRALIA-US BILATERAL INVESTMENT IN 2020: TAXING TIMES

STEPHEN KIRCHNER | JULY 2021

UNITED STATES
STUDIES CENTRE

The United States Studies Centre at the University of Sydney is dedicated to the rigorous analysis of American foreign policy, economics, politics and culture. The Centre is a national resource, that builds Australia's awareness of the dynamics shaping America – and critically – their implications for Australia.

The Centre's Trade and Investment Program examines trends, challenges and opportunities in the trade and investment relationship between Australia and the United States. It places the Australia-US economic relationship in the broader context of Australia's relations with the rest of the world and promotes public policy recommendations conducive to the growth and integration of the Australian, US and world economies.

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Research conclusions are derived independently and authors represent their own view, not those of the United States Studies Centre. Reports published by the United States Studies Centre are anonymously peer-reviewed by both internal and external experts.

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Cover photo: Getty

EXECUTIVE SUMMARY

- US investment in Australia has declined for three consecutive years and Australia has underperformed peer economies in attracting US capital.
- Global foreign direct investment (FDI) flows decreased by 38 per cent in 2020 to only 1 per cent of world GDP, their lowest since 2005.
- For the Organisation for Economic Co-operation and Development (OECD) area, FDI inflows fell by 51 per cent. Australia's experience was in line with the rest of the OECD, with a 48 per cent decline in inward FDI transactions.
- But US FDI transactions in Australia underperformed, with an inflow of just $1.1 billion in 2019, followed by an outflow of $12 billion in 2020, the first such outflow since 2005.
- The total value of two-way investment between Australia and the United States was just under $1.8 trillion in 2020, down from a record $1.85 trillion in 2019.
- The decline was driven by an $84 billion decline in the value of US investment in Australia. Australian investment in the United States rose by nearly $27 billion.
- The stock of US foreign direct investment in Australia fell by $25 billion, while Australian FDI in the United States rose by nearly $22 billion in 2020.
- The value of Chinese FDI transactions in Australia across 2019 and 2020 was greater than from the United States, +$6 billion in total for China versus -$11 billion for the United States despite the fact that China's global outward investment fell to a 13-year low in 2020.
- Data from the US Bureau of Economic Analysis shows that US FDI in Australia on a historical cost basis peaked in 2014 at US$177.4 billion and fell from US$169.7 billion in 2017 to US$162.4 billion in 2019, a decline of 4.3 per cent over the two years since the passage of President Trump's *Tax Cuts and Jobs Act* (TCJA) in 2017.
- On the Bureau of Economic Analysis (BEA) measure, US FDI in Australia between 2017 and 2019 underperformed that in Australia's peer economies and regions, including Canada, the United Kingdom, New Zealand, the euro area and the Asia-Pacific region excluding Australia.
- The biggest decline in US investment in Australia in 2020 was due to a $43 billion decline in portfolio investment in debt securities and an associated $33 billion decline in financial derivatives hedging these and other exposures.
- This most likely reflects US investors liquidating debt securities to raise and repatriate cash during the pandemic. At least some of this outflow will likely be reversed in subsequent years.
- The one bright spot in US investment in Australia in 2020 was portfolio investment in equity securities, which saw an inflow of $9 billion, the largest inflow since 2017, which partly offset the outflow in debt securities.
- The downturn in foreign investment in Australia, including from the United States, can be explained by the pandemic downturn in global investment, a reduced Australian international borrowing requirement, more competitive US tax settings and an increase in regulation and regulatory uncertainty arising from Australia's foreign investment review process. However, US investment in Australia still underperformed in relative terms.
- The United States will become less competitive in attracting foreign capital relative to Australia as a result of the Biden administration's proposed increase in the US corporate tax rate. However, the Biden tax changes will also reduce investment by US firms globally, so the implications for US investment in Australia are ambiguous.
- An agenda for increasing foreign, including US, investment in Australia, includes corporate tax reform, streamlining the regulation of foreign direct investment and re-opening the borders to facilitate due diligence on cross-border deals.

INTRODUCTION

The Australia-US bilateral investment relationship has traditionally been Australia's single most important source of foreign financing for domestic investment and economic growth. The relationship provides Australian borrowers with access to the world's deepest and most liquid capital market. It also complements the strong diplomatic and security relationship between the two countries.

Yet the bilateral investment relationship has shown significant weakness over the last three years and Australia has underperformed peer economies in attracting US capital, even before the onset of the pandemic in 2020. The pandemic-induced downturn in global investment and cross-border capital flows, excess saving and weak investment demand in Australia, US tax changes and Australia's regulation of foreign investment are all potentially implicated in this weakness. Although the pandemic and President Trump's tax changes are likely to be mainly temporary influences, Australian policymakers need to pay increased attention to policy settings that may be deterring US investment in Australia, even as some of these temporary negative influences moderate.

The pandemic led to substantial repatriation of investment globally, as international investors sold assets to raise cash and limit risk exposure. Global FDI flows decreased by 38 per cent in 2020 to only 1 per cent of world GDP, their lowest since 2005. For the OECD area, FDI inflows fell by 51 per cent.[1] Australia's experience was in line with the rest of the OECD, with a 48 per cent decline in inbound foreign direct investment transactions. But US FDI transactions in Australia saw an outflow of $12 billion in 2020 after only $1.1 billion in new direct investment in 2019.[2] This was the first outflow of US direct investment since 2005; then the result of a single large corporate restructure.

Over the same period, Australia has seen a dramatic reduction in its international borrowing requirement. An increase in domestic saving and weak domestic investment have resulted in record current account surpluses as a share of GDP, reducing the need for foreign capital inflow. Treasury expects the current account to remain in surplus until 2022-23. The surplus for 2020 was $49 billion, a $36 billion increase on the previous year.

The financial account recorded a net capital outflow of $154 billion in 2020 compared to an inflow of $5 billion in 2019. If the US share of that net capital outflow were the same as the average US share of the stock of foreign investment between 2001 and 2017 at around 26 per cent, then we would expect a reduction in US investment of around $41 billion. But US investment transactions in Australia saw outflows of $102 billion in 2020, accounting for 66 per cent of the overall net capital outflow. So, not all of the weakness in US investment can be attributed to a simple reduction in Australia's international borrowing requirement.

APART FROM THE PANDEMIC AND ITS IMPLICATIONS FOR AUSTRALIAN DOMESTIC SAVING AND INVESTMENT, PRESIDENT TRUMP'S CORPORATE TAX CUT IN 2017 HAS LIKELY WEIGHED HEAVILY ON US INVESTMENT IN AUSTRALIA BY MAKING AUSTRALIA A LESS ATTRACTIVE INVESTMENT DESTINATION ON A RELATIVE BASIS.

The outflow of US investment in 2020 mostly took the form of a reduction in portfolio investment in debt securities and associated derivatives hedging those investments, as US investors sold overseas assets to raise cash during the pandemic. However, direct investment transactions and the stock of US FDI in Australia as a share of GDP both fell in 2020 for the third straight year.

Getty

Apart from the pandemic and its implications for Australian domestic saving and investment, President Trump's corporate tax cut in 2017 has likely weighed heavily on US investment in Australia by making Australia a less attractive investment destination on a relative basis. While the new Biden administration will again revamp the US corporate tax system, it remains to be seen how this change will affect US corporate investment, including US corporate investment abroad. The United States will become a less competitive destination for investment, making Australia more attractive on a relative basis, but US corporates can be expected to reduce their investment both at home and abroad in response to a higher overall tax burden.

Australia could improve its policy settings with respect to inbound investment, which could help underpin economic recovery, especially if Australia once again becomes a net borrower internationally. The federal government's 2021 Budget implements some of the recommendations of a report by the Australia as a Financial and Technology Centre Advisory Group, which will help make Australia a more attractive investment destination.

However, Australia has the third-highest tax burden on capital income among 30 OECD countries, pointing to the continued need for corporate tax reform.[3] Australia's increased screening of FDI and associated increased application fees for foreign investors, while unofficially targeted at China, weighs more heavily on the United States as the larger overall investor in Australia because of its non-discriminatory application. The closure of Australia's borders has also impeded the ability of foreign investors to do due diligence on Australian acquisitions.

A renewed focus on corporate tax reform and international tax rules in Australia would attract more inbound investment, including from the United States. Both Australia and the United States could advocate for a corporate cash flow tax with full expensing of investment in the context of multilateral tax negotiations over a new global minimum corporate tax. Under this approach, taxes are only charged when profits are moved out of a business and not when a business reinvests its profits.[4] Grubert and Altshuler have suggested a minimum tax on foreign earnings of US companies that fully exempts the cost of new investment.[5]

Streamlining the regulation of inward FDI on the part of established investors to reduce delays and uncertainty and lowering the burden of application fees for foreign investors could also benefit foreign investment. My Foreign Investment Uncertainty Index found uncertainty doubled in 2020 relative to 2019,[6] although has moderated in the first quarter of 2021.

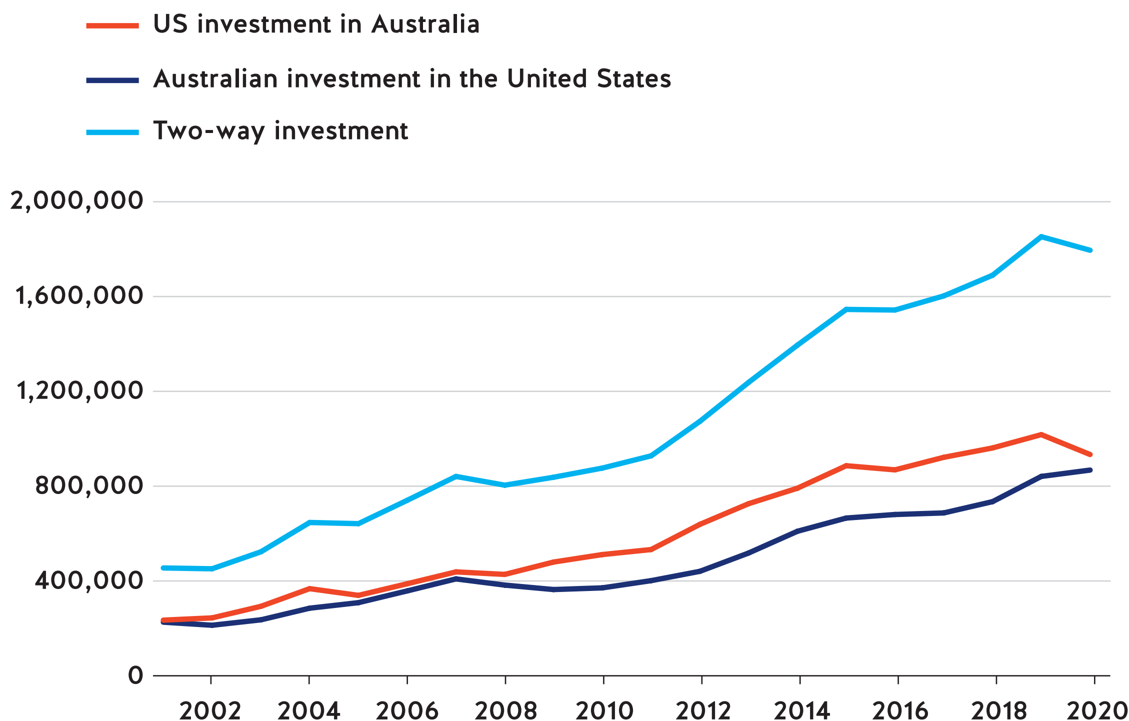
A progressive, risk-based re-opening of Australia's borders and increase in net overseas migration relative to pre-pandemic levels, as recommended in my United States Studies Centre (USSC) report *Avoiding US-style demographic stagnation*,[7] would also help facilitate due diligence on FDI transactions and given that immigration is highly complementary to cross-border trade and investment.

THE BILATERAL INVESTMENT RELATIONSHIP: THE STOCK PERSPECTIVE

The bilateral investment relationship can be viewed from the perspective of both stocks and flows. Stocks measure the accumulation of foreign investment and reflect valuation effects from movements in exchange rates and prices, while flows measure underlying transactions at a given point in time.

In stock terms, the total value of two-way investment between Australia and the United States was just under $1.8 trillion in 2020, down from a record $1.85 trillion in 2019 (Figure 1). The decline was driven by an $84 billion decline in the value of US investment in Australia. Australian investment in the United States rose by nearly $27 billion.

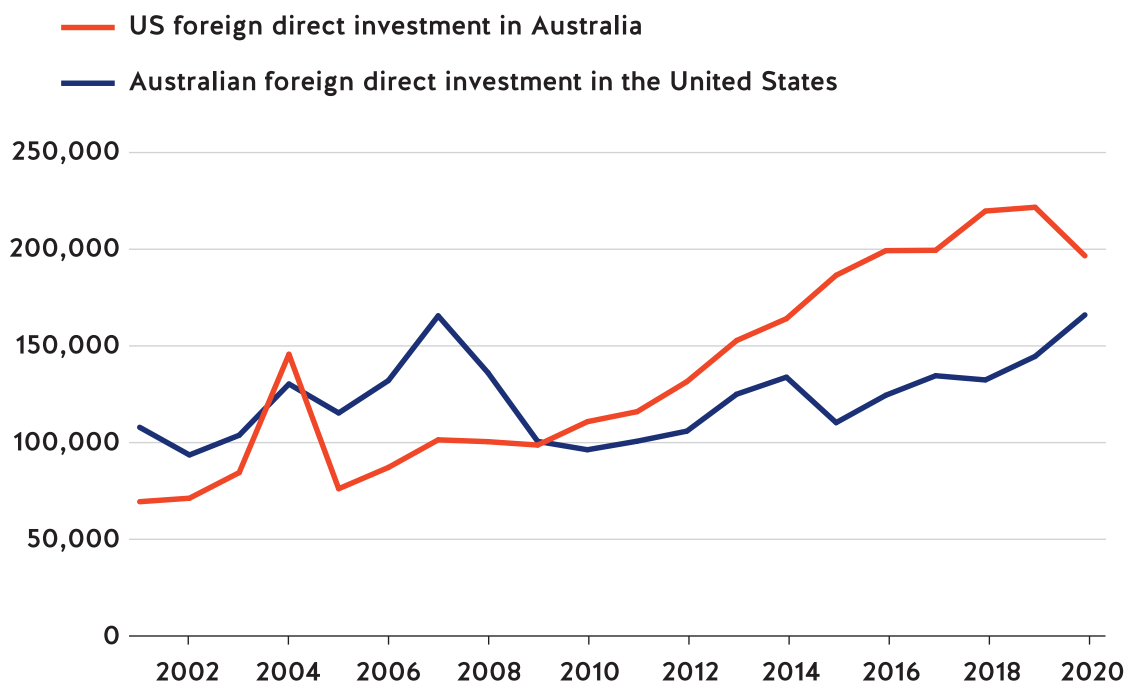
Figure 1. Bilateral investment relationship – stock ($m)



Source: Australian Bureau of Statistics

The stock of US foreign direct investment in Australia fell by $25 billion, while Australian FDI in the United States rose by nearly $22 billion (Figure 2). The level of direct Australian investment in the United States remains below that of the United States in Australia but is once again converging in value. Data from the US Bureau of Economic Analysis[8] shows that US FDI in Australia on a historical cost basis (that is, excluding subsequent valuation changes) peaked in 2014 at US$177.4 billion and fell from US$169.7 billion in 2017 to US$162.4 billion in 2019, a decline of 4.3 per cent over the two years since the passage of the *US Tax Cuts and Jobs Act* (Figure 3).

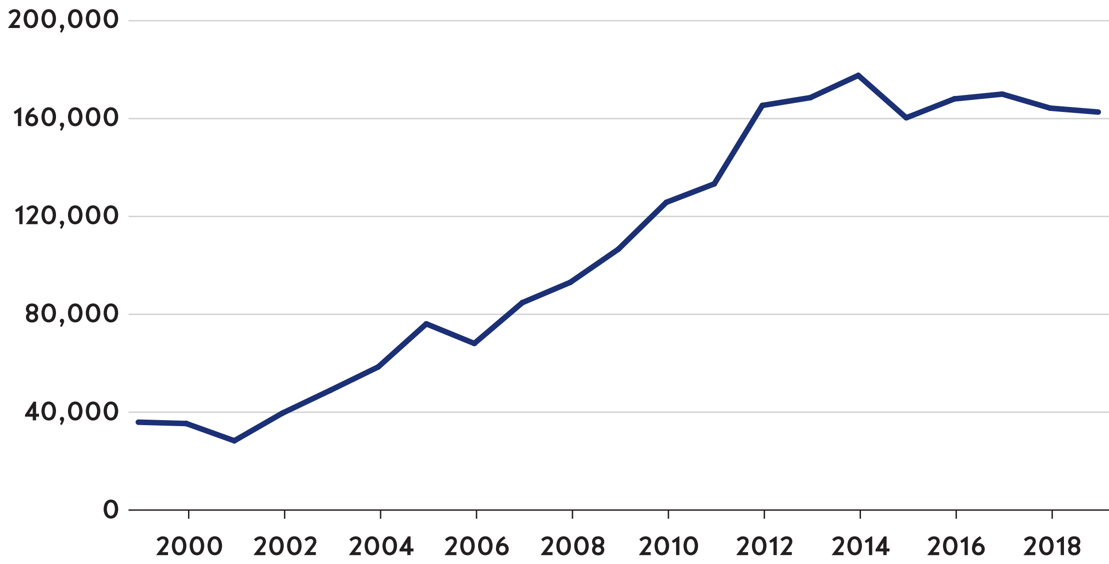
Figure 2. Foreign direct investment relationship – stock ($m)



Source: Australian Bureau of Statistics

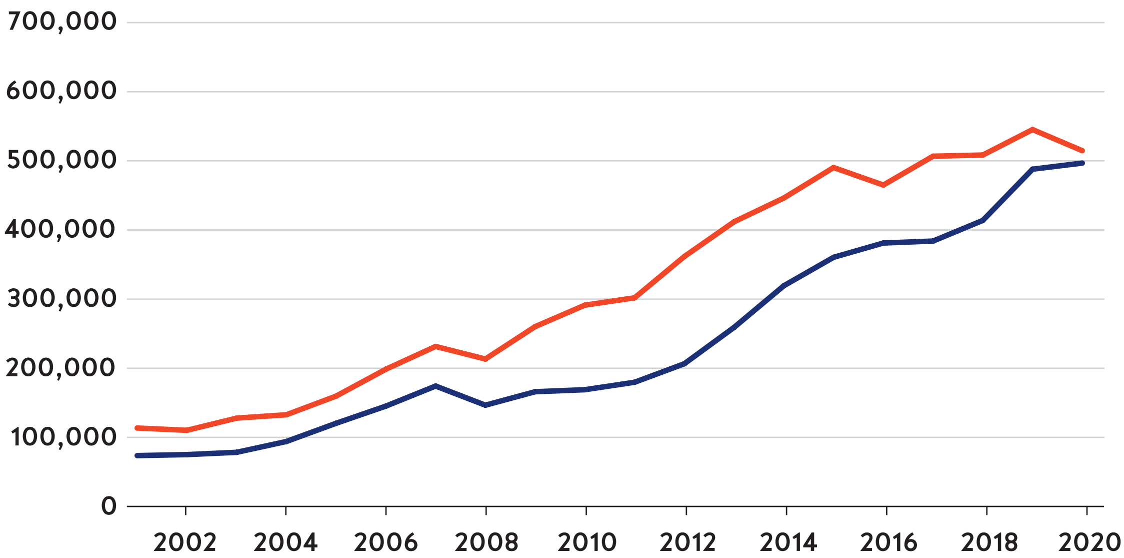
US portfolio investment in Australia fell by $35 billion in value terms, while Australian portfolio investment in the United States increased by $10 billion (Figure 4). Repatriation of US portfolio investment, as US investors sought to raise cash during the pandemic, together with the unwinding of associated hedging through financial derivatives, were the main sources of weakness in the overall investment relationship in 2020.

Figure 3. US direct investment in Australia ($m), historical cost basis



Source: US Bureau of Economic Analysis. Value for 2004 is suppressed by the BEA and has been estimated by the author.

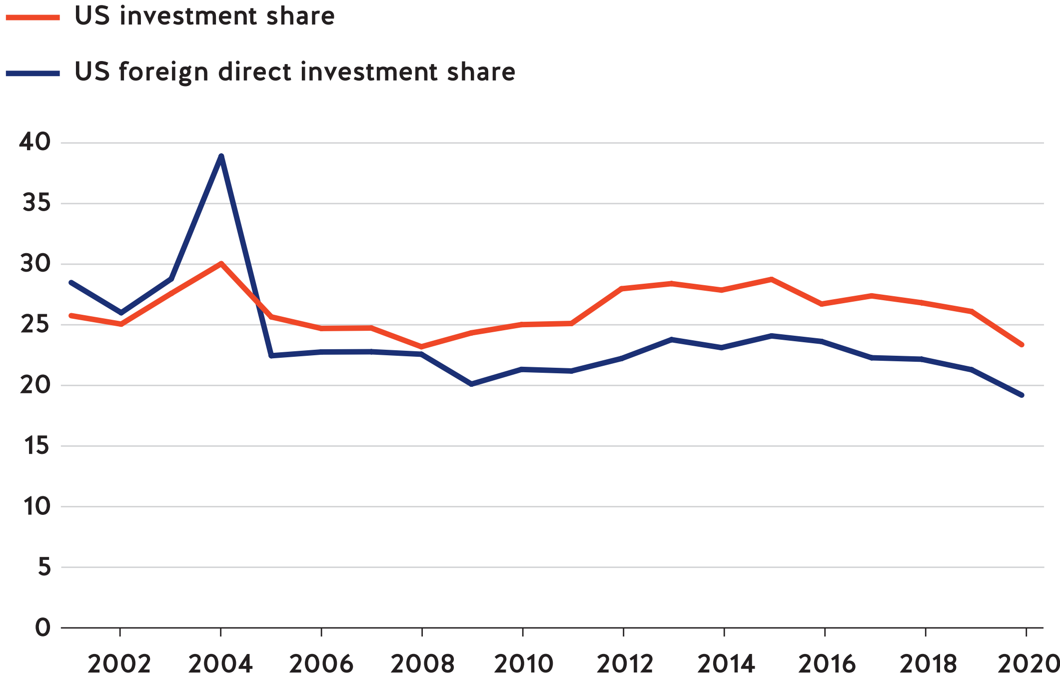
Figure 4. Portfolio investment relationship – stock ($m)



Source: Australian Bureau of Statistics

The US share of the stock of total foreign investment in Australia has been declining for three consecutive years, while the US share of the stock of FDI has now declined for two years (Figure 5).

Figure 5. US share of foreign investment in Australia – stock (%)



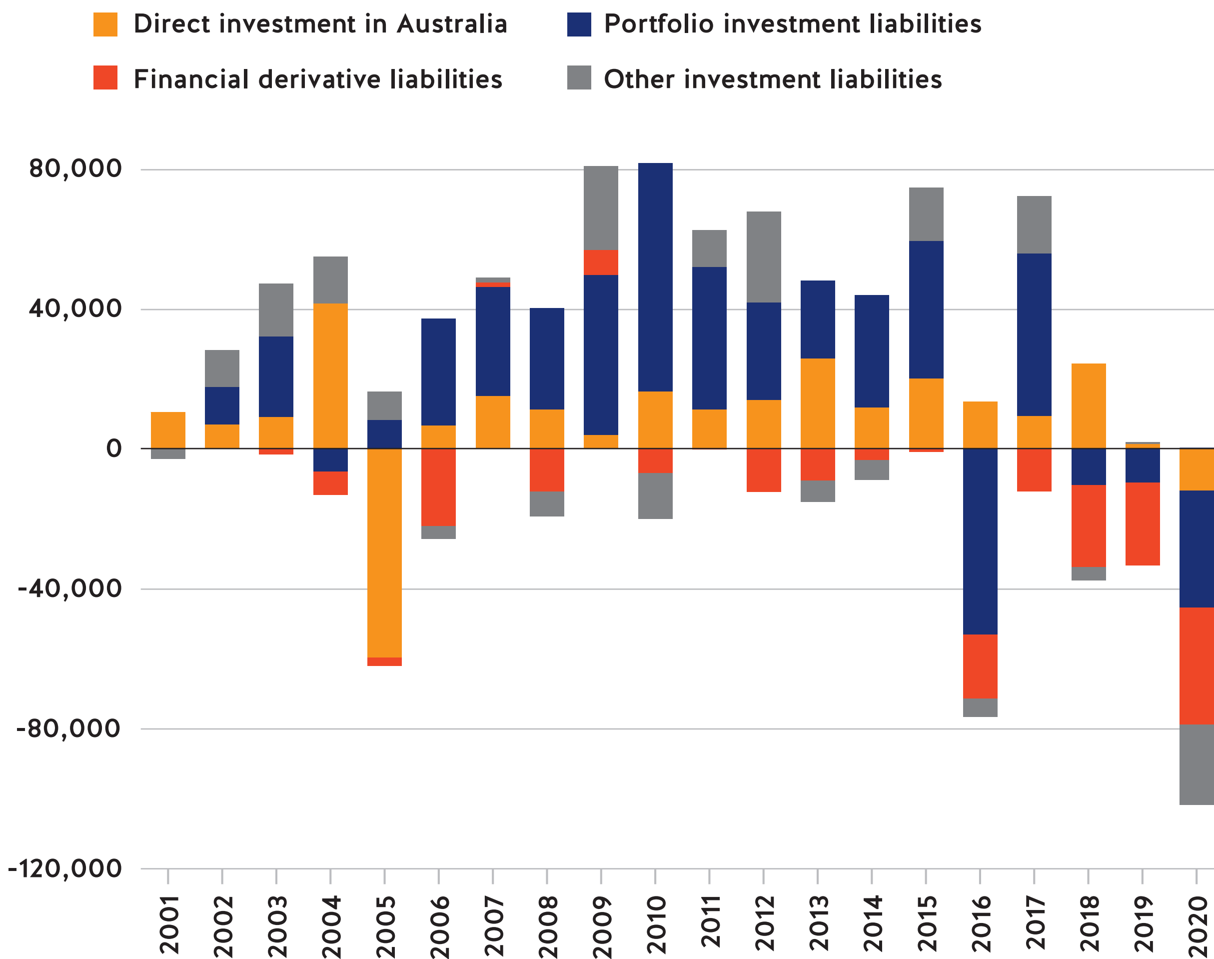
Source: Australian Bureau of Statistics

THE BILATERAL INVESTMENT RELATIONSHIP: THE FLOW PERSPECTIVE

With outflows of just over $100 billion, 2020 was a bad year for US investment flows into Australia. This was the third consecutive year of such outflows. The reduction in US investment notionally accounted for 66 per cent of the overall reduction in Australia's net external financing requirement in 2020. Over the last three years, Australia has lost nearly $150 billion in US investment.

In terms of FDI, US investment in Australia saw an outflow of $12 billion in 2020, the first outright decline in US FDI in Australia since 2005, which was then the result of a single large corporate restructuring. The year before (2019) was barely positive, with just over $1 billion in investment. The value of Chinese FDI transactions in Australia across 2019 and 2020 was greater than from the United States, +$6 billion in total versus -$11 billion for the United States. This is despite China's global outward FDI falling to a 13-year low in 2020.[9] The weakness in US direct investment in Australia in 2020 was offset by increased transactions from Japan (+$8.9 billion), France (+$14.2 billion), New Zealand (+$1.2 billion) and Ireland (+$1.5 billion) compared to 2019, highlighting the underperformance of US investment in Australia relative to that from other peer economies.

Figure 6. US investment transactions in Australia ($m)



Source: Australian Bureau of Statistics

Several factors likely account for the weakness in FDI in recent years. During the pandemic, it is likely US parents were borrowing from their Australian affiliates to raise cash. Australian affiliates are also likely to be paying off loans from their US parents. President Trump's tax reforms mean that interest deductions on loans to US subsidiaries are less valuable. To the extent that US affiliates in Australia have been losing money or paying more in dividends to their US parent than income received, this could be expected to weigh on re-invested earnings. A decline in re-invested earnings accounts for 58 per cent of the decline in US FDI in Australia in 2020.

The weakness in US investment in Australia was reflected in public market cross-border mergers and acquisitions (M&A) transactions, a subset of FDI, where foreign bidder activity was at a decade low in 2020, continuing a three-year downward trend. Less than half of proposed foreign acquisitions were successful, the lowest success rate in 10 years.[10] Of four large prospective deals with a US bidder in 2020, only one was completed and it was less than half the size of one large deal with a Chinese bidder which was successfully concluded (Table 1).

Table 1. Public cross-border mergers and acquisitions in 2020

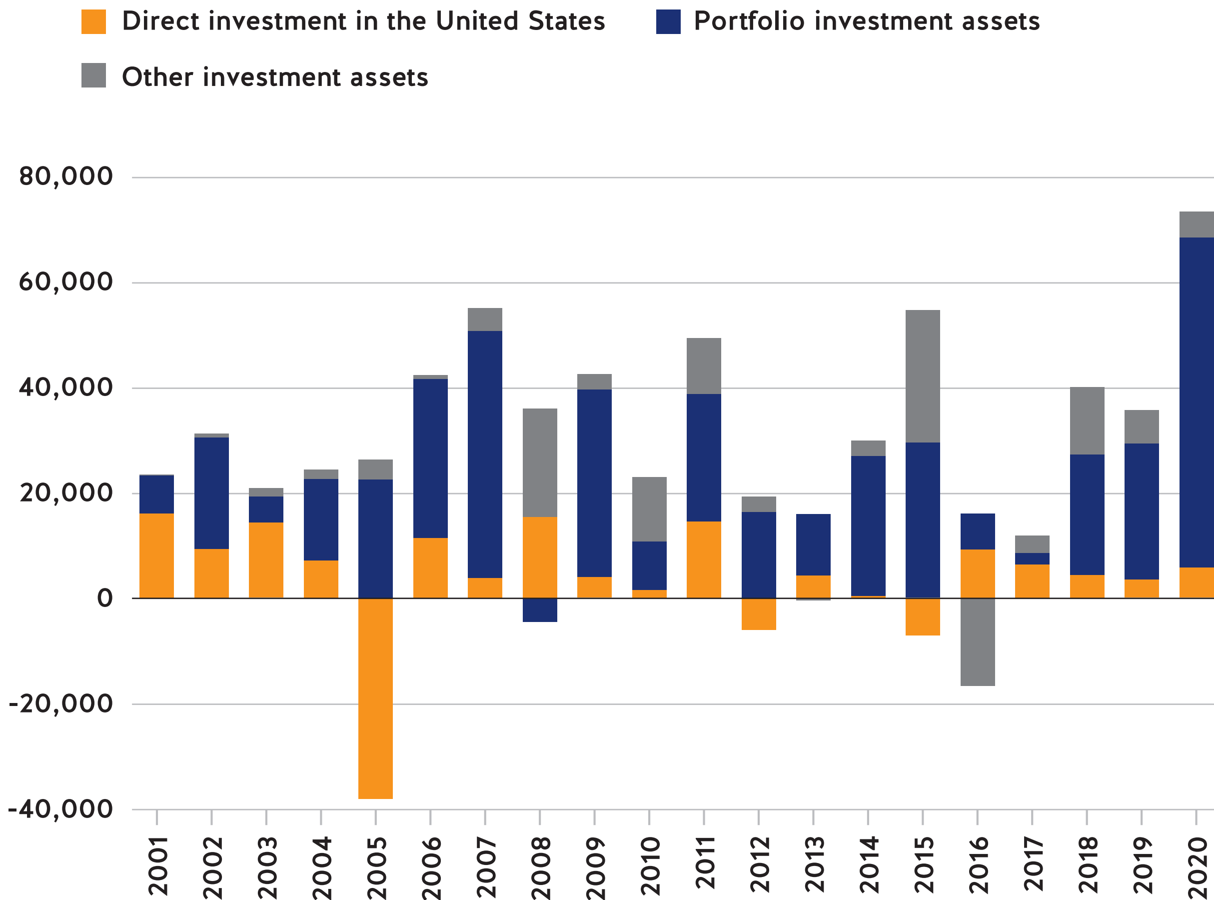
Target	US bidder	Type	Status	Final transaction value ($m)
Australian Unity Office Fund	Starwood Capital	Off-market takeover	Withdrawn	485
3P Learning	IXL Learning	Scheme	Withdrawn	188
Pioneer Credit Limited	Robin BidCo	Scheme	Withdrawn	120
National Veterinary Care Ltd	Aus Vet Owners League	Scheme	Completed	249
Target	**Chinese bidder**	**Type**	**Status**	**Final transaction value ($m)**
Cardinal Resources	Shandong Gold Mining	Off-market takeover	Successful	565

Sources: Gilbert and Tobin, *Takeovers and Schemes Review 2021*; Herbert Smith Freehills, *Australian Public M&A Report 2020*

The biggest decline in US inward investment transactions was due to a $43 billion outflow of portfolio investment in debt securities and an associated $33 billion outflow in financial derivatives hedging these and other exposures. This most likely reflects US investors liquidating debt securities to raise and repatriate cash during the pandemic. At least some of this outflow will likely be reversed in subsequent years. The one bright spot in US inward investment transactions was portfolio investment in equity securities, which saw an inflow of $9 billion, the largest inflow since 2017, which partly offset the outflow in debt securities.

Australian investment transactions in the United States rose strongly in 2020, driven largely by portfolio investment in equity and debt securities, showing the largest flows into the United States since 2001. (Figure 7).

Figure 7. Australian investment transactions in the United States ($m)



Source: Australian Bureau of Statistics

Portfolio outflows reflect a growing share of superannuation assets being invested abroad as domestic capital markets become increasingly saturated with superannuation saving. The share of superannuation assets invested in Australia has been on a declining trend, from more than 90 per cent in the late 1980s and early 1990s, to 82 per cent more recently.[11]

Australian direct investment in the United States rose from $3.4 billion in 2019 to $5.6 billion in 2020 but below that seen in previous years. Australia's overall direct investment transactions abroad were little changed in 2020, so Australian FDI in the US outperformed. On a flow basis, Australia has been a bigger overall investor in the United States over the last three years than the United States has been in Australia, including direct investment.

HOW DOES US FOREIGN DIRECT INVESTMENT IN AUSTRALIA COMPARE?

Overall US FDI outflows were unchanged in 2020 versus 2019 at around $US94 billion.[12] US FDI in Australia can be benchmarked against other countries and regions using US data that measures FDI positions on a consistent basis (see Table 2). For reference, Table 2 also shows the change in the current account balance over the same period as a proxy for the change in the country or region's overall external financing requirement.

Over the two years 2017-19, growth in US FDI in Australia significantly underperformed peer economies such as Canada, the United Kingdom, New Zealand and regions such as Europe and the Asia-Pacific. This suggests recent weakness in US direct investment in Australia is specific to the Australia-US investment relationship, rather than being driven by weakness in US FDI more broadly. While Australia also had the largest reduction in its implied net external financing requirement as measured by the change in the current account balance as a share of GDP, both Canada and the United Kingdom also saw reductions in their external financing requirements while still enjoying strong growth in US FDI.

Table 2. US foreign direct investment, selected countries/regions, 2017-19

	% change US FDI	Change in current account balance (ppts of GDP)
Canada	8.3	0.7
Europe	-2.3	-0.7
United Kingdom	4.5	0.7
Asia-Pacific	1.8	-
Australia	-4.3	3.2
New Zealand	-3.0	-0.4
Asia-Pacific ex-Australia	3.1	-

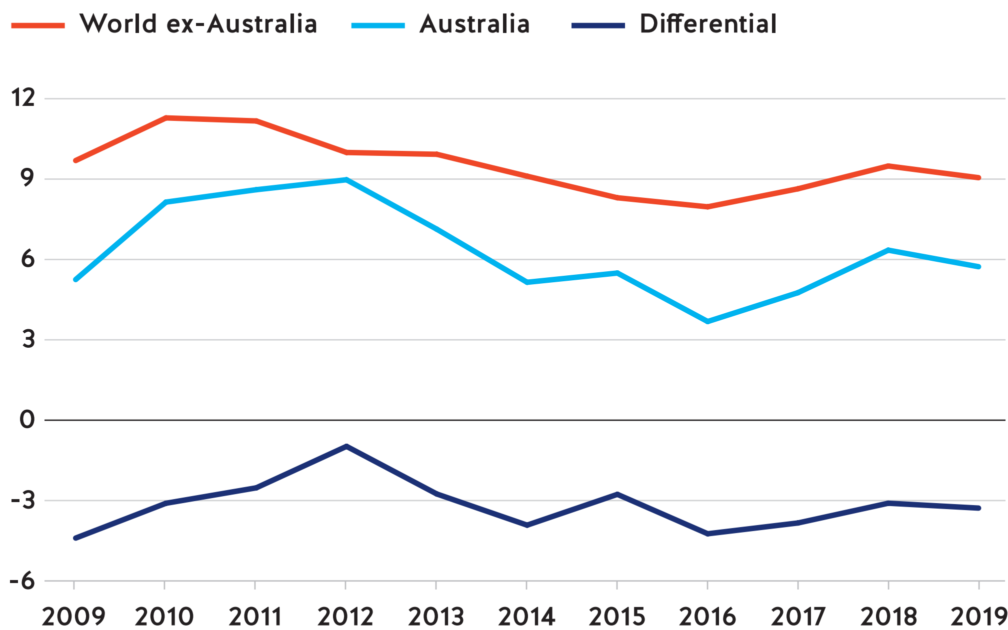
Sources: US Bureau of Economic Analysis; OECD

Note: In 2019, the euro area includes Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain

RETURNS TO US FOREIGN DIRECT INVESTMENT IN AUSTRALIA

It is possible to calculate the average return on US FDI in Australia by dividing income without current cost adjustment earned by US multinational enterprises (MNE)'s in Australia by their FDI position.[13] This can be compared with average returns on US FDI abroad ex-Australia (Figure 8).

Figure 8. Average return on US foreign direct investment abroad (%)



Source: US Bureau of Economic Analysis; author's calculations

The return on US FDI in Australia in 2019 averaged just under 6 per cent, which is in line with the return to FDI in developed economies.[14] This is a little lower than the 9 per cent return seen around the peak of the mining boom earlier in the 2010s. While the return to FDI in Australia is lower than for US FDI in the rest of the world ex-Australia, this is to be expected given the high returns available in some developing economies relative to Australia's developed country peers. There is no clear long-term trend in the return differential between US FDI in the rest of the world and US FDI in Australia that could explain the recent weakness in US investment in Australia, which suggests any weakness is due to changes in post-tax, not pre-tax returns.

FACTORS EXPLAINING RECENT WEAKNESS IN US INVESTMENT IN AUSTRALIA

Several factors can help explain the recent weakness in US investment in Australia. Some are temporary and can be expected to see US investment in Australia recover in the years ahead. Other factors are potentially ongoing but are amenable to being addressed through public policy.

The pandemic. The global economic downturn associated with the pandemic has weighed heavily on both business investment and cross-border capital flows. The pandemic has made due diligence on cross-border transactions more difficult. In Australia, the lowering of the monetary threshold for Foreign Investment Review Board (FIRB) scrutiny to zero resulted in significant delays in the foreign investment screening process. The lower threshold was introduced due to concerns the pandemic might lead to the opportunistic foreign acquisition of distressed Australian firms, in particular, by China. In the event, China's global FDI fell to its lowest in 13 years in 2020 and has been on a declining trend since 2016 due to its own controls on outbound FDI.[15] Australia also introduced a new national security test from 1 January 2021, which likely raised uncertainty while the legislation and associated regulations were under consideration by parliament during 2020. While these factors help explain the overall downturn in inward investment, they do not explain the relative underperformance of US investment specifically.

FOREIGN DIRECT INVESTMENT FROM OTHER JURISDICTIONS IS NOT A PERFECT SUBSTITUTE FOR US INVESTMENT AND MAY RESULT IN A LOSS OF SOME OF THE BENEFITS ASSOCIATED WITH ACCESS TO US MANAGERIAL TALENT, SUPPLY CHAINS, INTELLECTUAL PROPERTY AND INNOVATION.

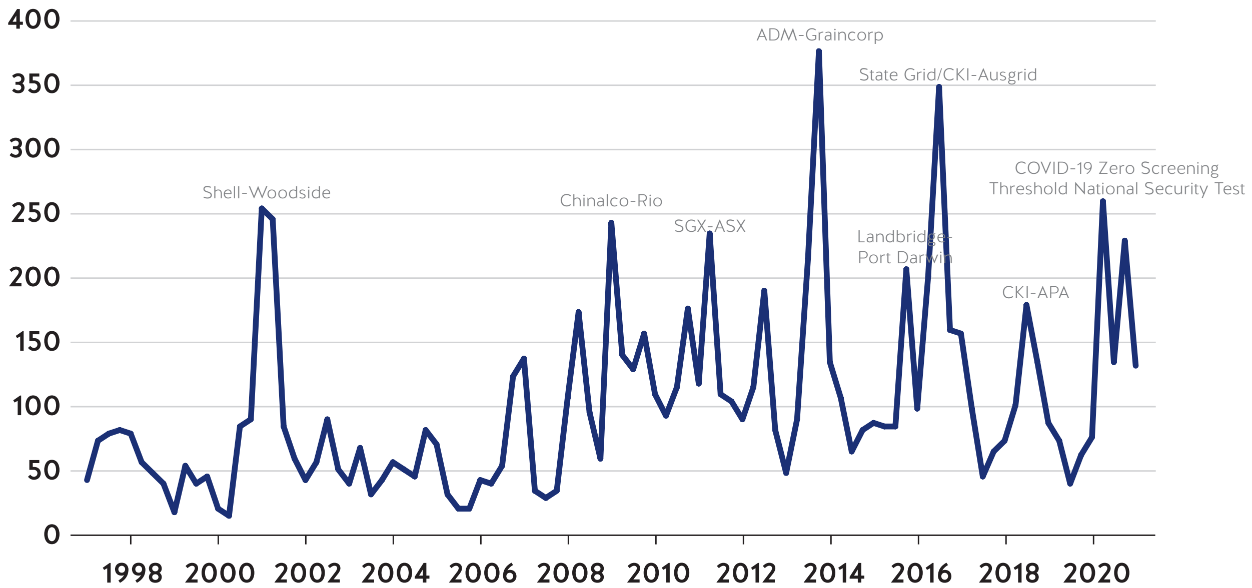
External financing requirement. As already noted, from the end of 2017 to the middle of 2020, Australia's current account saw a dramatic seven percentage point turnaround, from a deficit of 3.5 per cent to a surplus of 3.5 per cent of GDP, and 3.6 per cent of GDP in Q1 2021, the largest surplus on record. This implies a dramatic change in Australia's external financing requirement, from a net borrower internationally to a net lender. The reduced need for foreign capital inflow reflects both an increase in domestic saving and weakness in domestic investment. The current account balance is cyclical and can be expected to return to a deficit as the economy recovers, assuming it can once again grow close to the trend. Treasury's 2021 Budget assumes an eventual return to a deficit. However, the increase in the Superannuation Guarantee rate from 1 July 2021 and in subsequent years will contribute to Australia's excess saving problem, all else equal.

While the reduction in the overall financing requirement can help explain a reduction in US investment in absolute terms, it cannot explain a reduction in US investment in relative terms. While overall foreign capital inflows are mostly fungible, the benefits of FDI tend to be investor-specific. FDI from other jurisdictions is not a perfect substitute for US investment and may result in a loss of some of the benefits associated with access to US managerial talent, supply chains, intellectual property and innovation.

FDI regulation and uncertainty. Australia has the fifth most restrictive regulatory regime for FDI based on the OECD's FDI Restrictiveness Index[16] and continues to impose additional requirements on foreign investors, including a new national security test and increased application fees that act as a tax on inward investment. The Productivity Commission has quantified the cost of some of these regulations in terms of lost investment.[17]

While not targeted at the United States specifically, regulatory uncertainty and costs can still be expected to weigh on US investment. The Australia-US Free Trade Agreement provides significant relief from this burden relative to non-FTA countries, but inward FDI from the United States can

Figure 9. Foreign Investment Uncertainty Index – Australia



Sources: Factiva; author's calculations

Note: Historical mean = 100

still trigger FIRB scrutiny and consequent delays, costs and uncertainty, particularly if an entity in a non-FTA jurisdiction is involved in the transaction. In the case of global transactions, Australian subsidiaries will sometimes be off-loaded to Australian buyers, if only temporarily, to avoid FIRB delays affecting the global transaction. A recent PricewaterhouseCoopers (PwC) report highlights some of the ways in which US investment is caught, despite raising few policy issues, and proposes measures to streamline approvals.[18]

The USSC's Foreign Investment Uncertainty Index found a near doubling in policy-related uncertainty over 2020 compared to the average for 2019, largely due to the reduction in FIRB screening thresholds in response to the pandemic and the new national security test.[19] The first quarter of 2021 saw a 60 per cent reduction in uncertainty to its lowest level since the onset of the pandemic, as the monetary thresholds for investment screening reverted to normal from 1 January and more clarity was provided around the operation of the new test. The latest update to the Index is shown in Figure 9.

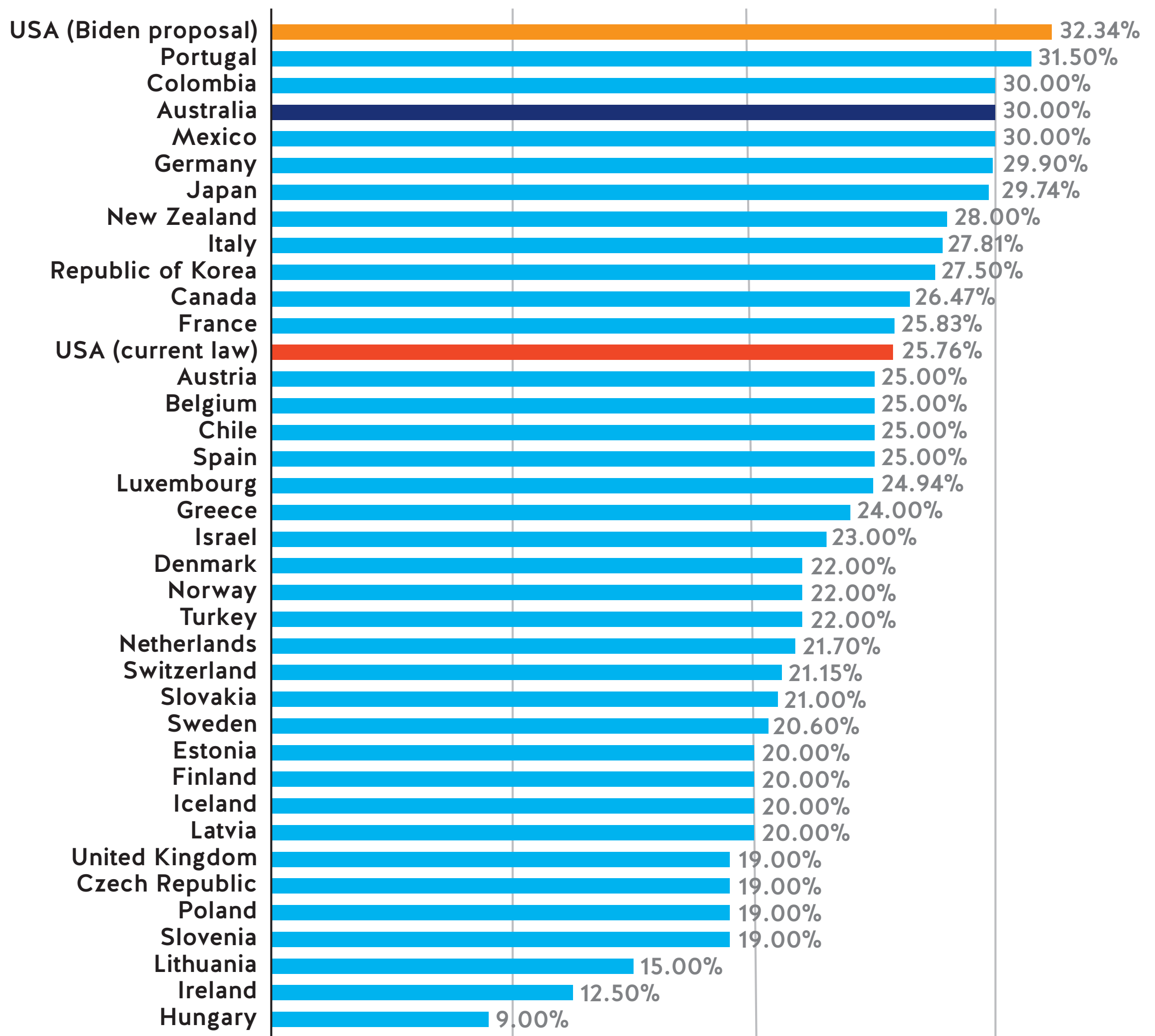
Taxation. The passage of President Trump's *Tax Cuts and Jobs Act* (TCJA) at the end of 2017 was always expected to weigh on US investment in Australia by cutting the US federal corporate tax rate from 35 per cent to 21 per cent, below Australia's rate of 30 per cent, and closer to the OECD average (Figure 10). This left Australia's corporate tax rate among the highest in the OECD.

By increasing the after-tax return on investment in the United States, the corporate tax cut could be expected to have negative spillovers on investment in the rest of the world, including Australia, to the extent that any resulting increase in US investment is financed from abroad (the United States runs a current account deficit). In the event,

the investment response was lacklustre and the United States has experienced a decline in inward FDI 'driven by the corrosion of US openness to trade and global cooperation' under the former Trump administration.[20]

The TCJA changed US corporate taxation from a worldwide system of taxation with deferral to a territorial system. US MNC's could previously defer the realisation of income for tax purposes by not repatriating income from controlled foreign corporations (CFCs) to their US parents, which tended to erode the US corporate tax base. The TCJA excluded dividends from CFCs from taxable income but also included provisions to limit the incentives for profit-shifting. These changes were widely expected to induce repatriation of foreign earnings after 2017 when the legislation was passed.

Figure 10. Statutory corporate tax rates in the OECD (combined national and sub-national rates), 2022



Source: Tax Foundation

The Biden administration's *Made in America Tax Plan* will increase the corporate tax burden and penalise both the domestic and foreign activity of US firms, reducing both domestic and global investment. The Biden plan will likely see a significant restructuring of the international ownership and operations of US firms away from US ownership and in favour of foreign ownership.[21] The Biden tax plan thus has mixed implications for US investment in Australia. While Australia's relative competitiveness as an investment destination will improve under the plan, US corporates will likely reduce their investment both at home and abroad in response to the higher corporate tax burden.

The Biden administration has also proposed a global minimum corporate tax of 15 per cent as part of OECD-sponsored multilateral tax negotiations. This is a lower rate than the administration's original proposal of 21 per cent, which was supported by the Australian Government.

As high corporate tax jurisdictions, the United States and Australia have a common interest in reducing international tax competition. By narrowing corporate tax differentials in favour of high tax jurisdictions, proposals for a global minimum tax and other measures could increase FDI to Australia. According to one estimate, the complete elimination of corporate tax differentials within the OECD at a common rate of 12.5 per cent would see a 20 per cent increase in inward investment in Australia due to its high tax status, but at the expense of other small open economies with currently lower corporate tax rates.[22] As the analyst noted, the OECD's proposed corporate tax reforms 'would punish the world's best-performing economies with regard to economic freedoms, trade and investment openness and the rule of law.'[23] As much as 40 per cent of global FDI moves through these low-tax investment hubs.[24] The current proposals for a global minimum corporate tax would adversely affect investment through these hubs.

AN AGENDA FOR INCREASING US INVESTMENT IN AUSTRALIA

As Australia recovers from the pandemic, domestic investment will recover, the external financing requirement will increase and once again see net capital inflows that have historically underpinned Australia's economic growth. While foreign capital inflows are to some extent fungible, this is not true of foreign direct investment. FDI is accompanied by transfers of managerial skill, entrepreneurial talent, intellectual property and access to firm-specific global supply chains. US direct investment in Australia is not a perfect substitute for other forms of foreign capital inflow. We should therefore be concerned about a shift in the composition of foreign capital inflows away from the United States.

REFORMING THE AUSTRALIAN CORPORATE TAX SYSTEM TO LOWER THE TAX BURDEN ON CAPITAL IN AUSTRALIA AND MAKE AUSTRALIA'S INTERNATIONAL TAX RULES MORE COMPETITIVE WOULD HELP CEMENT ANY ADVANTAGE FROM THE BIDEN ADMINISTRATION ADOPTING A TAX SYSTEM THAT WILL BE ONE OF THE LEAST COMPETITIVE IN THE OECD AND BRING AUSTRALIA'S CORPORATE TAX RATE INTO LINE WITH THE OECD AVERAGE EX-THE UNITED STATES.

Australia's federal and state governments devote significant resources to investment attraction and facilitation, not least in the United States. However, these efforts are often undermined by domestic policy settings that are unfriendly to foreign capital. Marketing efforts abroad need to be matched by improved domestic policy settings at home.

The 2021 Federal Budget contained some measures that can be expected to attract increased foreign investment, including the establishment of a fast-track process to provide investors with greater certainty around the tax implications of large investments, finalising the implementation of the Corporate Collective Investment Vehicle regime and establishing a more efficient licensing regime for foreign financial service providers. These measures are consistent with the recommendations of a report by the Australia as a Financial and Technology Centre Advisory Group.[25] These changes will help offset some of the other factors weighing on foreign investment.

Australia can further improve its attractiveness to foreign capital in general and US capital more specifically through the following reform agenda.

Corporate tax reform. Reforming the Australian corporate tax system to lower the tax burden on capital in Australia and make Australia's international tax rules more competitive would help cement any advantage from the Biden administration adopting a tax system that will be one of the least competitive in the OECD and bring Australia's corporate tax rate into line with the OECD average ex-the United States. Abolishing interest withholding tax on interest paid to foreigners lending into Australia would also attract foreign capital while reducing the budget balance by around $1.2 billion, based on Parliamentary Budget Office estimates.[26]

Adopting the 'high road' of domestic corporate tax reform would be preferable to the 'low road' of joining the Biden administration's efforts to cartelise the multilateral tax system in favour of high tax jurisdictions at the expense of small open economies with lower corporate tax rates. While a narrowing in corporate tax differentials within the OECD would likely benefit foreign investment in Australia as a high corporate tax jurisdiction, it will also lead to a less dynamic world and Australian economy by reducing investment globally.

In the context of multilateral negotiations over a global minimum tax, both the United States and Australia could champion a corporate cash flow tax with full expensing of investment as a more investment-friendly alternative to current proposals. Under this approach, a tax liability is only incurred when profits are moved out of a business. If a business reinvests its profit, there is

no recognised profit for tax purposes. As well as being less distortionary for investment decisions, a cash flow tax is more simple and less costly to administer and comply with.[27]

Regulating FDI. Rationalising the foreign investment screening process to capture fewer transactions that are unlikely to raise significant policy issues should be a priority, an issue dramatised by USSC's Foreign Investment Uncertainty Index. US investment in Australia is unlikely to raise national security concerns and should benefit from a lighter regulatory touch. Ironically, many of the measures put in place to increase scrutiny of foreign acquisitions by non-traditional investors such as China have also hurt inbound investment by traditional partners like the United States because they are implemented on a non-discriminatory basis and because the United States is historically the larger investor.

US investors are likely to be less tolerant of illiberal screening regimes given the relative openness of the United States and opportunities to invest in other economies with fewer restrictions. For example, increased scrutiny of acquisitions by foreign government-linked entities can affect transactions involving US government pension funds. While non-discrimination is an important principle to uphold, investments from the United States raise far fewer national security issues and should therefore benefit from a lighter regulatory touch. Clearly articulating Australian policy on foreign investment and making foreign investment decisions consistent with that policy can help minimise the uncertainty that acts as a barrier to FDI. Corporate restructures involving no change in beneficial ownership should be eligible for a streamlined approval process. A passporting system for established US and other investors in Australia that pre-permissions certain types of acquisitions and that is periodically renewed would be preferable to the current system of reviewing acquisitions on a transaction-by-transaction basis.[28]

Re-opening the borders. Re-opening Australia's international borders will facilitate FDI by increasing the ability of prospective foreign bidders to conduct due diligence on transactions involving Australian assets, while also benefiting investment in those sectors reliant on cross-border people flows.

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A FOREIGN INVESTMENT UNCERTAINTY INDEX FOR AUSTRALIA AND THE UNITED STATES

STEPHEN KIRCHNER | APRIL 2021

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EXECUTIVE SUMMARY

- This report develops a new Foreign Investment Uncertainty Index for Australia based on a keyword search of major Australian newspapers from 1997 through to the end of 2020.
- The index finds that foreign investment uncertainty nearly doubled for the four quarters of 2020 compared to the average for 2019.
- This increase is attributable in part to the government's reduction in the foreign direct investment (FDI) review threshold to zero dollars as a response to the pandemic and the introduction of a new national security test.
- In previous years, uncertainty was driven by specific high-profile transactions that tested the operation of Australia's foreign investment framework.
- The single biggest increase in the index occurs in the context of the Australia-US bilateral investment relationship. This is due to the treasurer's rejection of Archer-Daniels-Midland's (ADM) bid for Graincorp in 2013.
- In 2020, the gross inflow of FDI from foreign investors fell to only half the average of the five years ending in 2019, with global FDI flows in retreat due to the pandemic downturn.
- The industry sectors most affected by foreign investment uncertainty in Australia are the energy and resources sectors, reflecting their high levels of foreign ownership and high-profile cross-border acquisitions that are more likely to become politicised.
- Applying the same methodology to the United States suggests the United States has historically much lower levels of foreign investment uncertainty due to a more narrowly focused regulatory review process.
- However, the United States also shows a dramatic rise in foreign investment uncertainty due to changes in legislation expanding the scope of its FDI screening process in 2018, as well as the effect of the Trump administration's policies.
- The increased prominence of national security concerns in the regulation of FDI in Australia and the United States is likely to see elevated levels of policy-related uncertainty in both countries, although policy and legislative changes can also have the effect of reducing uncertainty.
- Given the close security relationship between Australia and the United States, the increased prominence of national security concerns in FDI regulation is expected to drive further growth in the bilateral investment relationship with Australia's top investment partner.
- An increase in the Foreign Investment Uncertainty Index for Australia has a negative effect on private investment spending in Australia, although the effect is smaller and less persistent than for the Baker, Bloom and Davis Economic Policy Uncertainty Index.
- There is also a small effect from the index on the risk premium on Australia's sovereign debt, although this effect is not statistically significant.

INTRODUCTION

Australia's regulation of inward foreign direct investment (FDI) has often drawn criticism for creating uncertainty for foreign investors, as well as for Australians looking to sell their assets to foreigners. Much of this uncertainty arises from the power the *Foreign Acquisitions and Takeovers Act* (FATA) 1975 gives to the treasurer to reject foreign acquisitions that are deemed to be 'contrary to the national interest.' This discretionary authority is unpredictable in its application and can lead to the politicisation of cross-border investment transactions.

In 2020, the scope of the investment screening process was expanded with a new national security test designed to capture transactions of concern that would not otherwise trigger the existing national interest test. The government branded these changes as the most significant in 20 years.[1] The new national security test reflects recommendations made by the United States Studies Centre (USSC) report, *Deal-breakers? Regulating foreign direct investment for national security in Australia and the United States*.[2] However, our report recommended any new national security test should replace the existing national interest test which is based on broader economic and other criteria.

In response to the COVID-19 pandemic, the Australian Government also temporarily lowered the monetary threshold for the scrutiny of foreign acquisitions to zero dollars. This expanded the scope of the existing regulatory framework to effectively encompass all prospective foreign acquisitions.[3] The decision reflected concerns the pandemic downturn might lead to the opportunistic acquisition of distressed Australian firms by foreign interests. It led to a substantial increase in the workload of the Foreign Investment Review Board, as well as delays in decision-making. The pandemic saw a sharp fall in foreign investment inflows, with gross inflows from foreign investors in 2020 representing less than half those seen on average in the five years from 2014 to 2019.[4]

The Organisation for Economic Co-operation and Development (OECD) has produced a widely referenced measure of the restrictiveness of FDI regulation across countries. This measure shows Australia to be a relatively restrictive jurisdiction for foreign investment compared to its peers. This is largely due to the operation of its investment screening process.[5] The Productivity Commission has used this measure to quantify the cost of this regulation in terms of lost foreign investment and economic activity.[6] However, the OECD measure only captures the *de jure* regulatory framework. It does not necessarily measure uncertainties that arise from its application.

THIS REPORT DEVELOPS A NEW FOREIGN INVESTMENT UNCERTAINTY INDEX THAT SEEKS TO QUANTIFY AND MEASURE OVER TIME THE EXTENT OF REGULATORY, POLITICAL AND POLICY UNCERTAINTY AROUND FOREIGN DIRECT INVESTMENT IN AUSTRALIA.

This report develops a new Foreign Investment Uncertainty Index that seeks to quantify and measure over time the extent of regulatory, political and policy uncertainty around foreign direct investment in Australia. The index follows similar measures of economic policy uncertainty developed by Baker, Bloom and Davis[7] in measuring the appearance of keywords relating to uncertainty and Australia's foreign investment framework in newspapers.

The index developed here finds that the average level of foreign investment uncertainty in 2020 was nearly double what was seen over the four quarters of 2019. The increase in 2020 is attributable to the government's reduction in the FDI review threshold to zero dollars and the introduction of the new national security test. In previous years, uncertainty was mainly driven by specific high-profile transactions which tested the operation of Australia's foreign investment framework; whereas in 2020, changes in the framework itself generated the most uncertainty. Foreign investment uncertainty changed little in the decade from 1997-2007 but rose sharply from 2008 in

the wake of the financial crisis and the regulatory response to increased Chinese direct investment in Australia.

To put Australia's foreign investment uncertainty in context, this report searches for the same uncertainty keywords in United States newspapers, as well as terms relating to the operation of the US regulatory framework that are analogous to those in Australia. In contrast to Australia, the report finds negligible levels of measured policy uncertainty in the United States, reflecting the narrower scope and application of the US regulatory regime. This partly explains the appeal of the United States as an investment destination for Australian business.

However, like Australia, there is evidence of increasing uncertainty in recent years as the United States expands the scope of its framework due to national security concerns. The regulatory environment for foreign investment in Australia and the United States is likely to become more uncertain as national security concerns loom larger for policymakers in both countries. This is reflected in changes in FDI regulation. In principle, such legislative changes could both increase and decrease uncertainty and the index allows us to track these effects. Given the close security alliance between Australia and the United States, these changes are likely to drive growth in the already strong bilateral investment relationship despite uncertainty.

An increase in the Foreign Investment Uncertainty Index is shown to have a negative effect on private investment spending in Australia, although the effect is smaller and less persistent than for the broader Economic Policy Uncertainty Index. Foreign investment uncertainty affects a smaller number of economic decision-makers relative to broader measures of uncertainty. There is also a small, but not statistically significant, effect on the risk premium on Australian sovereign debt.

MEASURING FOREIGN INVESTMENT UNCERTAINTY

Until recently, it was difficult to measure economic policy uncertainty. However, advances in online databases and computing power have made new methodologies based on searches for keywords relating to uncertainty and economic policy more feasible. The Economic Policy Uncertainty Index developed by Baker, Bloom and Davis has demonstrated significant explanatory power for business cycle dynamics not found in other economic variables. In a previous USSC report, I showed how measures of economic policy uncertainty for Australia and the United States explain exchange rates and interest rates, as well as cross-border trade and investment.[8]

Policy-specific uncertainty measures have also been developed using the same methodology. Foreign direct investment policy is an obvious candidate for this methodology. The keywords associated with the regulation of foreign acquisitions are highly specific to the operation of the legislative and policy framework for FDI, making the identification of relevant newspaper articles relatively straightforward and unambiguous. It is also widely acknowledged the legal regulatory framework, as measured by the OECD restrictiveness index, does not always reflect its operation in practice. The in-principle restrictiveness of the regime may be less important to economic outcomes than the uncertainty it creates. Policy uncertainty can itself be a costly barrier to cross-border transactions and a form of implicit protectionism.

To construct the index, I search leading Australian newspapers for keywords relating to both uncertainty and foreign investment policy and legislation. The newspapers included in the sample are *The Australian*, *The Australian Financial Review*, *The Sydney Morning Herald*, *The Age* and *The Canberra Times*. Both print and online editions were searched. The sample period is from the beginning of 1997 to the end of 2020. *The Australian* newspaper only appears in the Factiva database from the middle of 1996. Given the importance of its coverage of issues related to foreign investment, it was considered essential to include it in the measure, even though a longer sample could have been obtained from its exclusion.

The keywords used in the search are shown in Table 1. Hashtags followed by a number are used to denote the number of letters that vary after a word stem. For example, reject#3 captures 'reject,' 'rejected' and 'rejection.' A question mark allows substitution for alternative spellings.

Table 1. Uncertainty and foreign investment keywords

Uncertainty keywords	Australian foreign investment keywords
uncertain#2	Foreign Investment Review Board
confus#3	FIRB
discretion	foreign invest#4
reject#3	foreign acquisition
surpris#3	foreign takeover
delay#2	national interest test
politici?ed	contrary to the national interest
block#2	national security test
secre#2	
non-transparent	
pandemic	

The foreign investment keywords are mostly unique to the context of FDI regulation. The uncertainty keywords include words that capture both uncertainty and policy decisions likely to increase uncertainty. 'Pandemic' is included as an uncertainty keyword because the pandemic itself gave rise to considerable uncertainty, but also to capture changes in foreign investment policy related to the pandemic.

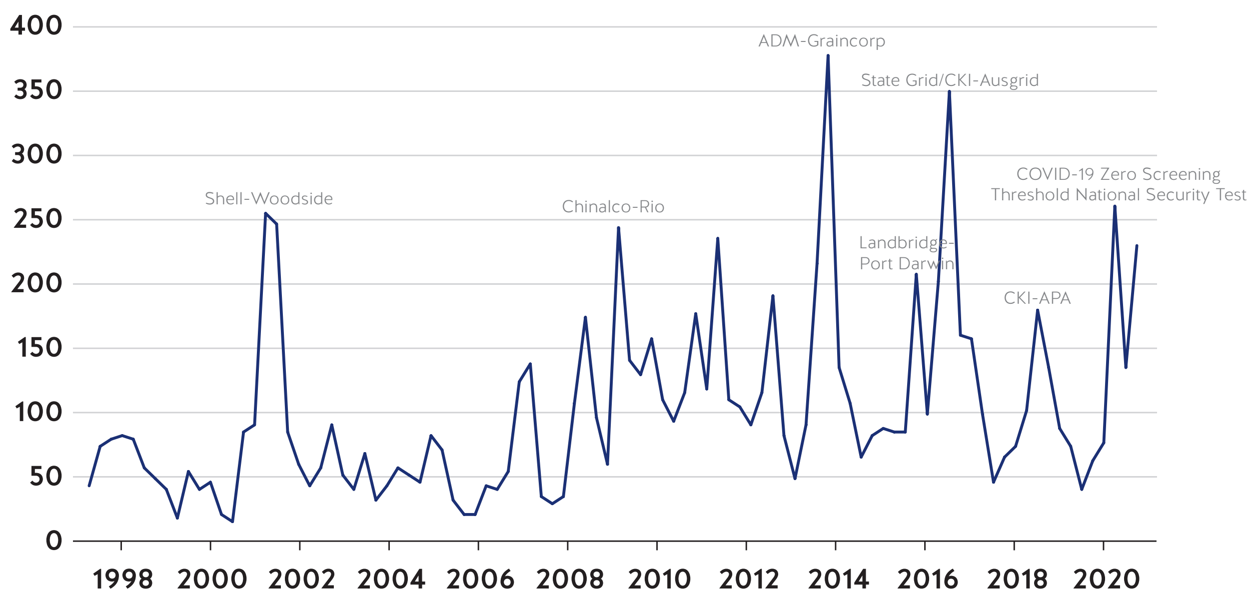
The search routine requires at least one uncertainty keyword to appear in the same paragraph (typically the same sentence) as at least one foreign investment policy keyword. Duplicate stories are eliminated from the count. The Baker, Bloom and Davis Index is normalised by the total number of stories, but such normalisation made little difference to the measure developed here and so only the unscaled story count is used. The unscaled story count was then standardised and normalised to a historical average equal to 100. The index is calculated on a quarterly basis.

Figure 1 shows the resulting index annotated with some of the high-profile rejections of cross-border acquisitions that have likely contributed to the uncertainty measured by the index.

The index shows remarkable stability over the decade from 1997 to 2007, punctuated only by the controversy over Treasurer Peter Costello's decision to reject Royal Dutch Shell's bid for Woodside Petroleum in 2001. This was considered an unprecedented decision at the time and results in one of the largest increases in the index.

Foreign investment uncertainty increased in the wake of the Global Financial Crisis in 2008 and following an influx of Chinese FDI into the resources, agricultural and property sectors. This uncertainty led the government to clarify the application of the foreign investment framework. However, the index indicates that these efforts resulted in more, rather than less, uncertainty. The failed bid by Chinalco to raise its stake in Rio

Figure 1. Foreign Investment Uncertainty Index – Australia



Sources: Factiva; author's calculations. Historical mean = 100.

Tinto in 2009 exemplifies confusion in Australia's FDI regulation at the time.[9] The Archer-Daniels-Midland (ADM) – Graincorp decision in 2013 results in the single biggest increase in the index. This is perhaps because it was contrary to the advice of regulators to the treasurer and occurred in the context of the otherwise stable Australia-US investment relationship.

It should be noted that the index is not a pure measure of uncertainty and may not capture the cumulative effect of foreign investment uncertainty over time. Causality could run from foreign investment to the index or run in both directions. Statistical tests reported in the appendix suggest the index is predicted by other economic variables and so may be partly endogenous.

Furthermore, the index does not necessarily capture decisions about FDI that are made in secret and therefore are never captured on the public record. In March 2020, Treasurer Josh Frydenberg said:

> *"I actually have rejected a number of proposed acquisitions, some of which you know about and some of which you don't. And the reason why you don't is because the application comes in, I assess it and I say no and then they withdraw that application before it ever sees the light of day."*[10]

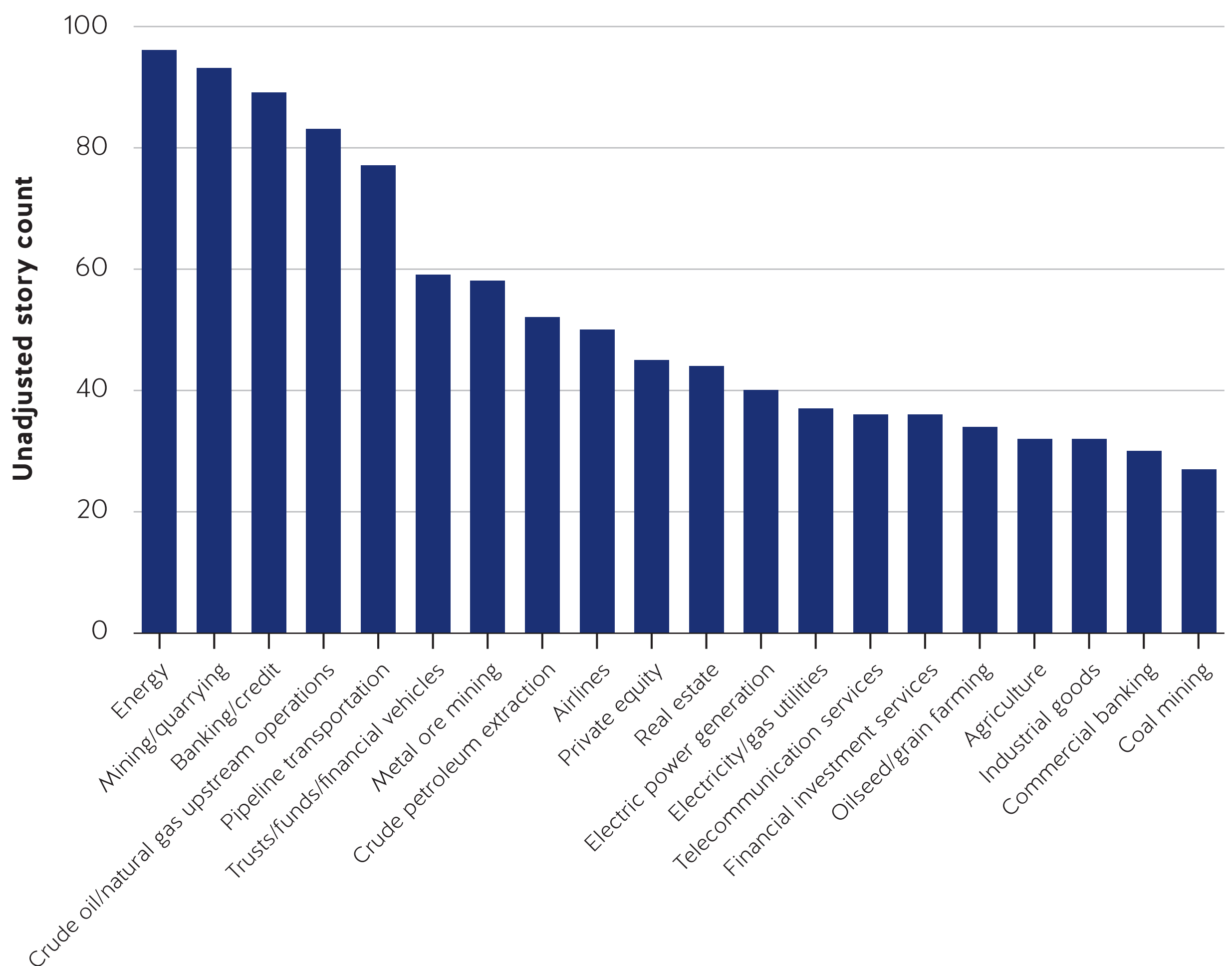
According to media reports, Chinese Government-backed cross-border acquisitions have been the subject of an informal Australian Government ban since the beginning of the pandemic, but this may not be fully reflected in the index.[11] Chinese cross-border acquisitions in Australia fell to $2.6 billion in 2019 and just $1 billion in 2020 compared to $16 billion in 2016, according to one database.[12]

INDUSTRY SECTORS MOST AFFECTED BY FOREIGN INVESTMENT UNCERTAINTY

The Factiva database classifies stories by industry, although the industry classification scheme mixes industry sectors and sub-sectors. Based on unadjusted story counts, it is possible to identify those industries and sub-sectors most affected by foreign investment uncertainty from the beginning of 1997 through to the end of 2020. This means a given story could potentially reference more than one industry or sector, or not be sector-specific and therefore not be counted by industry. The unadjusted story counts shown in Figure 2 need to be interpreted with some caution.

The energy and resources sectors feature most prominently. This reflects the high level of foreign ownership of this sector which has consequently also featured some high-profile and controversial cross-border acquisitions. Financial services also feature prominently, although this may reflect their role as intermediaries rather than as targets for foreign acquisition.

Figure 2. Top 20 industries affected by foreign investment uncertainty



Sources: Factiva; author's calculations

FOREIGN INVESTMENT UNCERTAINTY IN THE UNITED STATES

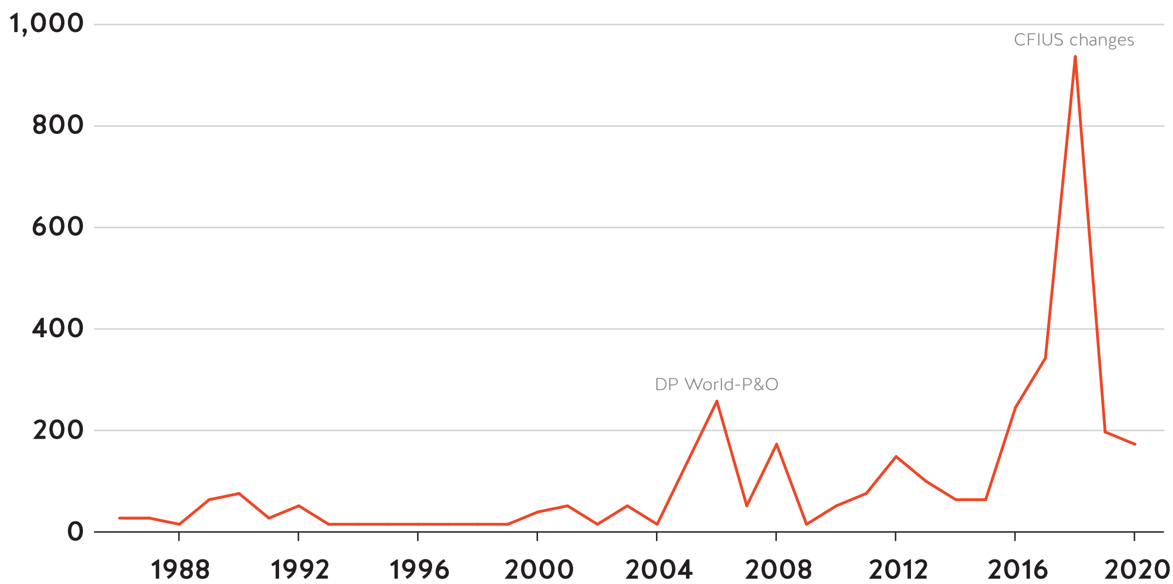
The same methodology can be applied to the United States by searching the same uncertainty keywords alongside terms specific to the operation of the US statutory framework for regulating foreign direct investment. The same US newspapers included in the Baker, Bloom and Davis Economic Policy Uncertainty Index are searched.[13] The search terms for the US foreign investment framework are shown in Table 2.

The index for the United States is shown in Figure 3.

Table 2. US foreign investment keywords

Committee on Foreign Investment in the United States
CFIUS
Foreign Investment Risk Review Modernization Act
FIRRMA
Foreign Investment and National Security Act
FINSA

Figure 3. Foreign Investment Uncertainty Index – United States



Sources: Factiva database; author's calculations

The US search, covering a larger number of titles over a longer period of time, returns negligible results for most years and far fewer results than Australian newspapers. For example, no stories are captured between 1992 and 2000 (the results above have been scaled by one, as well as being standardised and normalised to a historical mean of 100). The stability in the index for much of its history points to a more predictable regulatory environment for foreign investment than found in Australia.

However, there is a dramatic increase in the number of stories towards the end of the sample period associated with changes to the US regulatory regime in 2018, as foreshadowed in my 2018 USSC *Deal-breakers* report with Jared Mondschein. In this case, the keyword search likely captures the prospective operation of the new regulatory framework. President Trump's broader economic and trade policies also likely increased investment uncertainty between 2017 and 2020.

As in Australia, controversial foreign acquisitions, such as Dubai Ports World's bid for several US ports in 2006, are shown to be associated with an uptick in uncertainty. Overall, the regulation of cross-border acquisitions has a much lower salience in the United States than in Australian media. This, in turn, reflects a lower likelihood for politicised cross-border acquisitions due to the operation of the US regulatory framework. It could also reflect cultural differences between the United States and Australia in perceptions of foreign investment such that foreign investment is inherently more controversial, and therefore more newsworthy, in Australia.

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THE ECONOMIC EFFECTS OF FOREIGN INVESTMENT UNCERTAINTY

As Figure 1 suggests, the Australian index shows the most volatility in association with high-profile and controversial cross-border acquisitions that are rejected under Australia's foreign investment framework. To that extent, the index clearly captures the operation of that framework. However, such high-profile acquisitions and subsequent rejections are more likely to arise when economic activity and overall FDI are relatively strong.

The index may be partly endogenous, limiting its explanatory power for other economic variables such as foreign and domestic investment. The economic effects from foreign investment uncertainty are likely to arise with a lag and have persistent effects, but these dynamics can be difficult to capture statistically. The modelling that follows should thus be treated as indicative rather than definitive. Its main function is to show that the index can be given economic interpretation, as well as being descriptive of the operation of Australia's foreign investment framework.

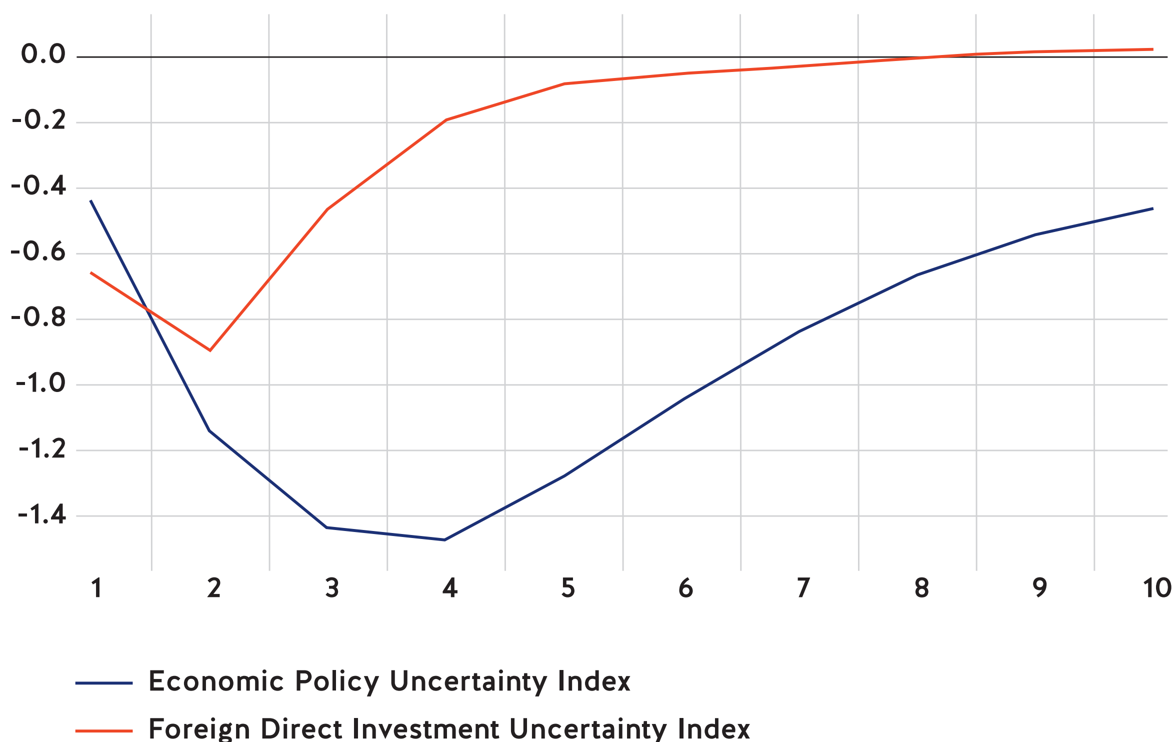
The index does not have much explanatory power for foreign direct investment transactions. In evaluating the economic effects of the index, it is not clear that foreign direct investment is the variable of interest. Foreign direct investment is the transfer of ownership of Australian equity capital to foreign persons and the timing of the transfer may be only loosely related to other economic variables. In and of itself, the transfer does not necessarily have significant economic effects in the short run, although it is widely acknowledged foreign ownership can lead to significant economic benefits over time. Again, these benefits can be difficult to capture statistically by focusing on short-run dynamics.

An arguably more relevant economic variable is private investment spending. It should be recalled that around 19 per cent of capital expenditure in Australia is by firms with at least 10 per cent foreign ownership,[14] which is the threshold used by the Australian Bureau of Statistics (ABS) for defining 'foreign ownership' when compiling FDI data. Foreign investment uncertainty could also affect the investment activity of wholly Australian-owned firms. For example, an Australian-owned firm that is prevented from selling its equity to a foreign entity may be unable to realise the full value of that equity, reducing the amount of other investment it is able to undertake in future. Foreign investment uncertainty may serve to devalue the stock of domestic equity capital, thereby increasing collateral and borrowing constraints. Foreign investment uncertainty may depress the investment activity of domestic as well as foreign firms.

In the appendix, I model the relationship between the Foreign Investment Uncertainty Index and the Economic Policy Uncertainty Index, the real effective exchange rate, the spread of 10-year Australian Government bonds over 10-year US Treasuries, real GDP, and private gross fixed capital formation. The modelling approach is similar to those that are used to evaluate the economic effects of economic policy uncertainty more generally.

The main finding is shocks to the Foreign Investment Uncertainty Index have smaller but still economically significant effects on private investment spending compared to economic policy uncertainty more generally. A one standard deviation shock to the Foreign Investment Uncertainty Index lowers private investment by 0.9 per cent after two quarters. By way of comparison, a one standard deviation shock to the Economic Policy Uncertainty Index lowers private investment by 1.5 per cent after four quarters (Figure 4). The larger and more persistent effect of the EPU Index likely reflects its impact on a much larger range of consumer and business decision-makers than FDI uncertainty. The number of decision-makers directly impacted by foreign investment uncertainty is much smaller than for economic policy uncertainty.

Figure 4. Dynamic response of private gross fixed capital formation to one standard deviation shocks to the Australian Economic Policy Uncertainty Index and Foreign Direct Investment Uncertainty Index (%)



Shocks to the Foreign Investment Uncertainty Index also have a small but not statistically significant effect (plus three basis points) on the Australian 10-year yield spread over US Treasuries, which can be interpreted as a risk premium. It should be noted this is the same order of magnitude as the estimated reduction in the risk premium from the Australia-US Free Trade Agreement (AUSFTA). This interpretation can be turned around to say that the AUSFTA was equal to a one standard deviation reduction in foreign investment uncertainty, as measured by the index.

While foreign investment uncertainty and economic policy uncertainty do not individually predict investment spending, they do predict investment spending when tested jointly with other variables in the model (see Appendix). Additionally, the Economic Policy Uncertainty Index predicts the Foreign Investment Uncertainty Index, indicating that the latter may capture elements of general policy uncertainty. Other model variables can also jointly predict the Foreign Investment Uncertainty Index, indicating that the index may be partly endogenous. The dynamic effects of FDI uncertainty may be difficult to capture in a simple, atheoretical model of this type. However, the results are consistent with foreign investment policy uncertainty having a role in the determination of domestic capital formation.

CONCLUSION

The Foreign Investment Uncertainty Index shows foreign investment uncertainty in Australia has increased over time. After showing little change over the decade from 1997 to 2007, there was a sharp increase in uncertainty from 2008 onwards coinciding with a pick up in Chinese FDI in Australia. This in turn prompted changes in Australia's regulatory regime which likely increased uncertainty by expanding the scope of the existing regulatory framework. Although Chinese investment in the resources sector triggered much of this uncertainty, investment by traditional investment partners has not been immune. The treasurer's rejection of ADM's bid for Graincorp in 2013, against the advice of domestic regulators, shows that the otherwise stable Australia-US bilateral investment relationship can also get caught up in domestic politics.

By contrast, foreign investment uncertainty has a much lower salience in the US media. This may reflect different cultural attitudes to foreign investment and thus the propensity to report on the regulation of foreign acquisitions. More importantly, it reflects a statutory framework for FDI regulation which is much narrower in scope. However, the United States does show a significant increase in measured uncertainty in recent years, reflecting the growing importance of national security concerns and changes to the US legislative framework designed to address these concerns, as well as the uncertainties associated with President Trump's economic and trade policies between 2017 and 2020. The increased prominence of national security concerns in FDI regulation in Australia and the United States is likely to drive further growth in the bilateral investment relationship given the close security ties between the two countries.

Shocks to the Foreign Investment Uncertainty Index have a negative effect on private capital expenditure, although a smaller and less persistent effect than that of broader economic policy uncertainty shocks, as measured by the Economic Policy Uncertainty Index. The role of foreign-owned firms in domestic investment spending is likely to be the main transmission mechanism, although foreign investment uncertainty can also devalue the stock of domestic equity capital, prompting an increase in collateral and borrowing constraints on domestic firms, and a reduction in their investment spending. There is also a small positive effect from such shocks on the Australian sovereign risk premium, although this effect is not statistically significant. While the index developed in this report clearly reflects the operation of Australia's foreign investment framework, the economic effects of such regulation are likely to have complex dynamics that are difficult to capture in simple models of this type.

THE FOREIGN INVESTMENT UNCERTAINTY INDEX SHOWS FOREIGN INVESTMENT UNCERTAINTY IN AUSTRALIA HAS INCREASED OVER TIME. AFTER SHOWING LITTLE CHANGE OVER THE DECADE FROM 1997 TO 2007, THERE WAS A SHARP INCREASE IN UNCERTAINTY FROM 2008 ONWARDS COINCIDING WITH A PICK UP IN CHINESE FDI IN AUSTRALIA.

APPENDIX: MACROECONOMIC EFFECTS OF THE FOREIGN INVESTMENT UNCERTAINTY INDEX

I examine the macroeconomic effects of the Foreign Investment Uncertainty Index for Australia in the context of a recursively-identified vector autoregression (VAR) model. The variables in the model include the Australian Economic Policy Uncertainty Index (*aepu*), the Foreign Investment Uncertainty Index (*fiui*) developed in this report, the Australian dollar real effective exchange rate (*reer*), the spread of the Australian Government 10-year bond yield over 10-year US Treasuries (*spread*), Australian real GDP (*gdp*) and Australian private gross fixed capital formation (*gfcf*). All variables except *spread* are in log form and enter in levels of the variable.

Variables are ordered as listed above, reflecting their assumed relative speed of adjustment. This allows us to recover orthogonal shocks using a Cholesky decomposition. A lag order of two is imposed, which ensures a parsimonious specification, while narrowly passing tests for the absence of serial correlation in the residuals. The adjusted sample period is Q3 1998 to Q4 2020.

The Australian Economic Policy Uncertainty Index is included in the model since it has previously been shown to have explanatory power for some of the variables in the system and to ensure that foreign investment uncertainty has effects distinct from more general policy uncertainty.

The effect of one standard deviation shocks to *aepu* and *fiui* on *gfcf* have already been shown in Figure 4. Investment spending declines 1.5 per cent after four quarters in response to economic policy uncertainty shocks, while foreign investment uncertainty shocks lower investment by 0.9 per cent after two quarters. The larger and more persistent effect of economic policy uncertainty can be attributed to the more generalised uncertainty it represents, affecting a larger range of economic decision-makers. Shocks to economic policy uncertainty increase foreign investment uncertainty, but there is not a statistically significant effect of foreign investment uncertainty on broader policy uncertainty. This is consistent with expectations that causality should flow from broader uncertainty to policy-specific uncertainty, rather than the other way around.

Other impulse responses are mostly consistent with economic theory. Shocks to both measures of uncertainty add three to five basis points to the yield spread, although this effect is not statistically significant. While economic policy uncertainty shocks lower the real effective exchange rate by 1.9 per cent after two quarters, the *fiui* does not have a statistically insignificant effect on the *reer*. Shocks to the yield spread raise the real effective exchange rate by 1.6 per cent, which is consistent with the theory. Real GDP shocks raise the level of private investment by 1 per cent after two quarters.

In addition to impulse response analysis, we can consider Granger causality and block exogeneity tests to identify the causal relationships among the variables. Since the variables are in levels, the Toda and Yamamoto[15] procedure is used to ensure the validity of the Wald tests as the basis for inference. The test statistics are shown in Table A1.

The test statistics indicate that the Foreign Investment Uncertainty Index does not have individual predictive power for other variables in the system, although it is jointly significant in explaining private investment spending. It is noteworthy that the other variables in the system jointly, and in the case of the Economic Policy Uncertainty Index, individually predict the Foreign Investment Uncertainty Index. This suggests the latter may be partly endogenous to other variables in the system. Given that investment spending is driven by the other economic variables in the system, it is likely to assume greater media salience in association with those variables.

These test statistics are highly sensitive to model specification and so should be taken as indicative only. However, they are consistent with the Foreign Investment Uncertainty Index being economically interpretable in the context of a simple, atheoretical model.

Table A1. VAR Granger causality and block exogeneity Wald tests based on the Toda-Yamamoto procedure

Dependent variable: LOG(AEPU)			
Excluded	Chi-sq	df	Prob.
LOG(FIUI)*100	3.669056	2	0.1597
LOG(REER)*100	0.728910	2	0.6946
SPREAD	1.780684	2	0.4105
LOG(GDP)*100	0.841113	2	0.6567
LOG(GFCF)*100	0.667335	2	0.7163
All	7.902811	10	0.6383

Dependent variable: SPREAD			
Excluded	Chi-sq	df	Prob.
LOG(AEPU)*100	0.666386	2	0.7166
LOG(FIUI)*100	0.551052	2	0.7592
LOG(REER)*100	0.624636	2	0.7317
LOG(GDP)*100	2.900787	2	0.2345
LOG(GFCF)*100	4.303354	2	0.1163
All	9.703373	10	0.4669

Dependent variable: LOG(FIUI)			
Excluded	Chi-sq	df	Prob.
LOG(AEPU)*100	6.230603	2	0.0444
LOG(REER)*100	4.900245	2	0.0863
SPREAD	2.807625	2	0.2457
LOG(GDP)*100	2.480859	2	0.2893
LOG(GFCF)*100	3.397982	2	0.1829
All	27.85395	10	0.0019

Dependent variable: LOG(GDP)			
Excluded	Chi-sq	df	Prob.
LOG(AEPU)*100	3.235905	2	0.1983
LOG(FIUI)*100	1.703566	2	0.4267
LOG(REER)*100	1.316651	2	0.5177
SPREAD	0.921976	2	0.6307
LOG(GFCF)*100	0.081110	2	0.9603
All	8.269873	10	0.6025

Dependent variable: LOG(REER)			
Excluded	Chi-sq	df	Prob.
LOG(AEPU)*100	1.040879	2	0.5943
LOG(FIUI)*100	0.095762	2	0.9532
SPREAD	4.568478	2	0.1019
LOG(GDP)*100	0.080017	2	0.9608
LOG(GFCF)*100	5.919968	2	0.0518
All	11.88200	10	0.2930

Dependent variable: LOG(GFCF)			
Excluded	Chi-sq	df	Prob.
LOG(AEPU)*100	2.823100	2	0.2438
LOG(FIUI)*100	0.567399	2	0.7530
LOG(REER)*100	2.396634	2	0.3017
SPREAD	8.516347	2	0.0141
LOG(GDP)*100	4.652148	2	0.0977
All	26.74002	10	0.0029

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DEAL-BREAKERS? REGULATING FOREIGN DIRECT INVESTMENT FOR NATIONAL SECURITY IN AUSTRALIA AND THE UNITED STATES

Stephen Kirchner and Jared Mondschein

July 2018

THE UNITED STATES STUDIES CENTRE
at the University of Sydney

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The United States Studies Centre's Trade and Investment Program examines trends, challenges and opportunities in the trade and investment relationship between Australia and the United States. It places the Australia-US economic relationship in the broader context of Australia's relations with the rest of the world and promotes public policy recommendations conducive to the growth and integration of the Australian, US and world economies.

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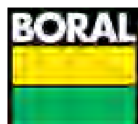

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Executive summary

- A change in the sources of foreign direct investment (FDI) in Australia and the United States has raised concerns about national security risks that may arise from such investments.
- Both Australia and the United States have mechanisms to screen FDI and retain statutory powers to block, or order the divestment of, foreign acquisitions. These processes are currently being revised to better protect national security.
- The issue for policymakers is how to maximise the benefits of foreign investment, while addressing legitimate national security concerns.
- Whereas Australia's regime is built around an open-ended 'national interest' test, the US process is explicitly directed at investment that 'threatens to impair the national security of the United States'.
- The Committee on Foreign Investment in the United States (CFIUS) provides a useful model for how Australia could reform its foreign investment screening process to better focus on national security issues, while leaving other non-security policy issues to domestic regulatory frameworks behind the border.
- Australia's process has been more focused on protectionism and has struggled to integrate national security considerations in a systemic way, resulting in confused policymaking and uncertainty for foreign investors.

Policy recommendations

- The government's discretion to reject foreign investment applications should be exercised only in relation to national security issues or cases where domestic regulatory frameworks are unable to address policy issues raised.
- Australia's Foreign Investment Review Board (FIRB) should be overhauled to better integrate consideration of national security and critical infrastructure issues. FIRB should report to the National Security Committee (NSC) of federal cabinet rather than the treasurer on national security issues. The NSC should be the decision-making authority rather than the treasurer.
- The Australian government should develop broad principles for assessing national security risks and make these principles publicly available. The principles should be suitable for multilateral adoption in free trade agreements and investment treaties. The process for applying these principles should be articulated in a publicly-available government guidance document.
- Critical infrastructure and other assets deemed too sensitive to allow foreign ownership should be identified either through statutory restrictions on foreign ownership or a negative list to increase certainty for foreign investors.
- FIRB should improve its reporting to parliament, including through confidential hearings to parliamentary committees to protect classified and commercially sensitive information.
- There is a lack of coordination between Australia and the United States in evaluating and addressing national security risks that may arise from foreign investment. A memorandum of understanding should be signed between the Australian and US governments for the exchange of information and setting out procedures for consultation and the joint consideration of cross-border acquisitions that raise common national security issues. This would complement existing 'Five Eyes' processes in relation to intelligence sharing.

Introduction

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Both the United States and Australia rely on foreign direct investment (FDI) as a major source of capital to fund domestic investment and economic growth. FDI has long been recognised as an important driver of productivity growth. FDI, usually defined as foreign ownership of 10 per cent or more of a company, commonly involves the transfer of technology, management techniques, intellectual property, and other forms of intangible capital. These knowledge transfers typically enhance productivity in the local operations of foreign-owned enterprises, but also generate spillover benefits for productivity in the rest of the economy. FDI is typically more long-term and more stable than other forms of capital inflow, like portfolio investment, usually defined as ownership of less than 10 per cent of a company. FDI gives foreign investors a long-term stake in the economy.

Cross-border acquisitions of domestic businesses and assets by foreign firms can be controversial and raise a number of potential issues for policymakers. One of the more difficult issues facing policymakers is how to trade-off the mostly well-understood benefits of FDI against potential threats to national security from foreign acquisitions.

While most foreign acquisitions do not raise national security concerns, security considerations have become more salient in recent years due to a change in the sources of FDI. Traditionally, most foreign investment in the United States and Australia was sourced from other developed Western market economies that also enjoyed close security ties through formal alliance relationships. In this context, FDI rarely raised national security concerns.

The rise of emerging market economies as net savers and exporters of capital in the world economy has seen the sources of inward FDI shift to countries such as China that have a more problematic strategic and security relationship with the United States and Australia. The prominent role of state-owned enterprises (SOEs) in outbound FDI from economies such as China raises concerns that such investments may have strategic rather than purely commercial motives. In Australia, an estimated 83 per cent of Chinese acquisitions by number and 60 per cent by value were from private investors in 2017.[1] In the case of the United States, 90 per cent of inward FDI still comes from private investors.[2] At the same time, however, the proportion of companies having 50

per cent or more government ownership among the Fortune Global 500 grew from 9.8 per cent in 2005 to 22.8 per cent in 2014.[3] In any event, even private firms can be responsive to demands from their governments. Intellectual property, technology, data and knowledge transfers have become more important as drivers of FDI and this may have security implications where these technologies or data have military applications or threaten to diffuse technology leadership from the United States and Australia to strategic rivals such as China.

China has increasingly resisted convergence with international market economy norms in favour of its 'Made in China 2025' state-led development model that aspires to global leadership in key industries and technologies with both civil and military applications. An important element of this mercantilist development and innovation strategy is the appropriation of knowledge and technologies through both inward and outward FDI. This industrial strategy is closely tied to China's strategic and military objectives and has been given added impetus through the consolidation of domestic political power under President Xi Jinping since 2012. These developments call for a re-evaluation and re-calibration of frameworks for the regulation of FDI to focus more squarely on national security issues at the border, but also more rigorous governance and security arrangements for sensitive assets and critical infrastructure behind the border.

Australia and the United States are not the only countries seeking to address the national security issues raised by foreign investment. The United Kingdom, which has traditionally maintained an open-door policy with respect to FDI, has sought to introduce increased screening at the border. Other EU countries have also sought to implement increased scrutiny of foreign acquisitions on a national and EU-wide basis.[4]

This report outlines some of the national security issues raised by recent changes in the sources of FDI in Australia and the United States. The regulatory regimes for screening FDI in both countries are examined, with a particular focus on how these regimes handle national security issues. The policy recommendations are focused on how Australia can improve its regulatory regime for FDI to better focus on national security issues, using the United States as a model for reform. The aim of the report is not to prescribe the detailed content of Australia's foreign investment policy. It is to articulate in general terms a better approach that elevates national security concerns to the centre of the FDI screening process by redefining the national interest test in terms of national security issues, while turning other issues over to domestic regulatory processes.

This can be done within the framework of current legislation, although would require a substantial re-writing of the government's existing foreign investment policy.

Why reform is needed

Both Australia and the United States have processes in place to screen FDI and retain statutory powers to block, or order the divestment of, foreign acquisitions. In Australia, this process is based on advice from the Foreign Investment Review Board (FIRB). In the United States, the process is administered by the Committee on Foreign Investment in the United States (CFIUS). Appendix 1 compares the FDI screening and approval processes in both countries. The most important difference between them is that whereas Australia's regime is built around an open-ended 'national interest' test, the US process is explicitly directed at investment that 'threatens to impair the national security of the United States'.[5]

The processes in both Australia and the United States are not as well-defined as they could be and have struggled to respond in a coherent and predictable way to some of the potential national security issues raised by recent foreign acquisitions. According to the Peterson Institute for International Economics, a US think-tank, "the CFIUS process…remain[s] opaque and grant[s] excessive discretion to the executive branch".[6] Similar criticisms have been made of Australia's FIRB.[7] This lack of transparency and excessive discretion has created uncertainty for foreign investors and may have a deterrent effect on FDI.

The challenge for policymakers is how to maximise the benefits of foreign investment, while addressing legitimate national security concerns. This requires a deeper understanding of how foreign ownership might affect national security, defence capabilities and critical infrastructure in both theory and practice. This understanding should then inform the institutions and processes put in place to screen FDI at the border and to regulate business investment behind the border. Without this understanding, acquisitions with substantial economic benefits may be blocked or deterred based on apprehended security concerns that are not well-founded. In the absence of this understanding and the implementation of sound review mechanisms, there is also an increased danger that the foreign investment review process becomes ad hoc and/or politicised.

Security concerns run in both directions between a source and host country. Foreign investors want to ensure that the value of their assets will be protected and not subject to arbitrary expropriation or divestment. To protect their assets, foreign investors, including foreign governments, have strong incentives to adhere to domestic law and avoid provoking retaliation by host country governments. The accumulated stock of inward FDI gives the host country leverage over foreign investors, including foreign governments. In the extreme case of armed conflict, FDI can be subject to expropriation by the host country government, inflicting economic and strategic harm on the source country. Indeed, the risks to the source country in this scenario are likely to be larger than to the host country to the extent that it has the larger stock of FDI at risk.

It is an open question as to whether economic integration through increased cross-border trade and investment reduces the likelihood of international conflict. The world was highly economically integrated before the First World War, but this did not prevent the outbreak of conflict. While there is a growing view that China has failed to converge on the international norms favoured by the United States and Australia, the underlying economic and political case for drawing China into the world economy remains valid. The regulation of foreign investment into Australia and the United States should be integrated with broader diplomatic and security strategies aimed at disciplining the behaviour of countries like China.

Indiscriminately pushing back against Chinese FDI could also be counter-productive and actually encourage China to double-down on its own protectionist actions and indigenous innovation strategy. If Chinese capital stays at home, it is more likely to be used to finance indigenous innovation at the expense of innovation in Australia, the United States and other allied economies. Failing to capitalise on Chinese investment may hinder domestic economic development, to the detriment of national security. The size of the economy is an important foundation for national security. The military, diplomatic, foreign aid and other capabilities Australia brings to its international and security commitments are ultimately constrained by the fiscal resources available to government, which in turn depend on the size of the tax base. This suggests a delicate balance between rejecting transactions that may pose specific national security risks while seeking to capitalise on the benefits of Chinese investment abroad.

Foreign direct investment and national security

There are a number of ways in which foreign acquisitions of domestic businesses and assets may give rise to national security concerns. Until recently, these concerns have been more apprehended than real. Rosen and Hanemann, experts on Chinese investment in the United States, made the following observation in 2011 before China's recent authoritarian turn:

> *We find the open-source literature on the security risks associated with Chinese firms to be full of overgeneralisations, mischaracterisations and weak evidence — oftentimes consisting in large part newspaper citations of work by journalists that do not carry sufficient evidentiary weight… We are aware of no damage to US national security that can be attributed to a faulty approval process.*[8]

This conclusion was also drawn in relation to foreign portfolio investment by sovereign wealth funds. According to David Marchick and Matthew Slaughter, "no one has pointed to a [sovereign wealth fund] investment that compromised national security in any country in the last five decades".[9]

More recently, attitudes towards China have hardened in both Washington and Canberra. There are now good reasons to be less sanguine about foreign investment from countries like China. China's increasingly assertive international economic and security policies make it prudent to consider the worst case scenarios arising from prospective foreign acquisitions. Probabilities can then be assigned to these scenarios and weighed against the economic benefits of a given transaction to make judgements about the appropriate policy response. Even if national security considerations are rarely invoked as a result of the FDI screening process, they are sufficiently important to require a well-developed and well-articulated process for analysing and addressing them. Even a single transaction could potentially undermine national security if not well handled.

Theodore Moran, a leading expert on the regulation of foreign investment, suggests a typology of national security threats that might arise in the context of FDI.[10] These are:

- Threats to reliability of supply to the defence sector or broader economy of critical goods and services.
- Threats arising from technology or data transfer to foreign interests.
- Threats arising from an increased potential for infiltration, surveillance or sabotage.

While it is easy to identify potential threats in principle, it is much more difficult to establish that there is an actual threat in practice from a particular foreign acquisition. A transaction that might be viewed as benign today may become less so in the future as strategic circumstances change. FDI screening processes cannot anticipate all future contingencies. The burden of protecting national security needs to be met behind the border over time, rather than at the border at a particular point in time. The case studies discussed in Appendix 2 demonstrate that, historically at least, some of the transactions that have raised national security concerns did not constitute genuine security risks or these risks were successfully mitigated. It is nonetheless useful to establish benchmarks or thresholds for thinking about how each of these threats might trigger formal review processes and decisions to reject particular transactions.

China's increasingly assertive international economic and security policies make it prudent to consider the worst case scenarios arising from prospective foreign acquisitions.

Reliability of supply

Competitive and open domestic and international markets provide the best security against possible attempts to restrict supply in ways that might be harmful to national security as well as to the economy. Most markets for key industrial and agricultural commodities are supplied in this context, making it unlikely that a foreign acquisition could pose a significant threat to security of supply. This is particularly the case for the United States and Australia, both of which are net producers and exporters of some commodities. For example, the issue of food security has been raised in the context of foreign acquisitions of Australian

agribusiness and agricultural land, but as a significant net producer and exporter of food, it is implausible that Australia could suffer from meaningful threats to food security through foreign acquisitions of Australian land or agribusiness.

Energy security has raised similar concerns, although these have become less salient for the United States and Australia given that both economies are increasingly significant exporters of energy, particularly natural gas. China's investments in oil and gas have sometimes raised concerns, but in the case of Chinese investment in oil production, almost all output is sold into world markets rather than being allocated specifically to the Chinese market.[11] Most commodity markets are sufficiently fungible that there is no advantage to selling into a specific, as opposed to world markets, although China and the United States have recently discussed LNG purchases as a means of addressing trade imbalances. Rare earths have also been the subject of Australia's FDI screening process on the basis of security of supply concerns, as discussed in one of the case studies in Appendix 2.

Concern over China's systematic, state-sponsored theft of foreign technology is legitimate, but increased restrictions on foreign investment may not be the right way to tackle the problem.

In principle, situations may arise where there is a single or small number of producers of a key technology or input, with few substitutes and high switching costs, which may give rise to security concerns, but this does not appear to be common in practice. Domestic competition policy addresses issues where mergers and acquisitions might reduce competition or supply in ways that are economically harmful and these regulatory frameworks can be applied without screening acquisitions at the border. If such acquisitions are not harmful from a competition policy perspective, it is unlikely they also pose a threat to the reliability of supply from a national security standpoint. Competition policy and strategic trade theory, which analyse the economics of markets that are imperfectly competitive, provide useful benchmarks for when a cross-border acquisition might threaten undue concentration or the reliability of supply. However, a notable characteristic of the literature in these fields is that these tend to be special cases that arise in theory more so than in practice.[12]

Technology, information and data security

There is a case for restricting foreign acquisitions involving sensitive military or dual-use technologies. Since technology and knowledge transfer are often important motivations for FDI, this concern is significant in principle. Typically, technology and knowledge transfers are a feature of outward FDI, with the benefits accruing to the host country and so this is less of a concern for the inward FDI screening process. However, technology and knowledge transfer can also run from host to source country.

China's use of joint venture arrangements to affect forced technology transfers from foreign firms in violation of the World Trade Organization's (WTO) Trade and Investment Measures and its own WTO Accession Protocol has become an important issue for the United States and a source of friction in the overall trade and investment relationship between the two economies. Recent research has shown that these often forced technology transfers have significant positive productivity and technology spillovers for the Chinese economy via US investment in China.[13] Chinese firms harvesting US technology through investments in start-ups and other entities that fly below the radar of the existing FDI screening process have become a key concern.[14]

Concern over China's systematic, state-sponsored theft of foreign technology is legitimate, but increased restrictions on foreign investment may not be the right way to tackle the problem. There are alternative, more targeted policy instruments that can be used.

Both the United States and Australia maintain export control and technology transfer regimes that are better tailored to address the issue of technology transfer from host to source country and these regimes are in the process of being enhanced. China's forced

Photo: Getty

transfers of intellectual property through joint venture and other arrangements can and should be challenged through the WTO or through targeted sanctions on offending Chinese firms.

Data and information security has become increasingly important and potentially raises national security issues that have already led to a failure to approve foreign acquisitions in the United States (see, for example, the Ant Financial-MoneyGram transaction discussed in Appendix 2).

Technology transfer and data security risks can potentially be mitigated without rejecting acquisitions in their entirety. Key technologies and intellectual property can be carved out of foreign acquisitions as part of the FDI screening process or addressed through appropriate governance arrangements.

Ideas want to be free and new technologies will eventually diffuse across international borders. That is mostly for the better. It is unrealistic to expect that the world's soon-to-be-largest economy will forever remain a technology laggard. However, the fact that China relies heavily on appropriating foreign technology is itself evidence that it is struggling to compete in fostering institutions and a culture conducive to innovation and progress. The history of state-directed economic development strategies such as 'Made in China 2025' is littered with costly failures. Japan in previous decades is an obvious example that also gave rise to security concerns about foreign investment similar to those now raised about China.

The main advantage the United States and Australia have over China is not specific innovations that will be appropriated by foreigners, either legally or illegally, but the institutional framework that sustains their creation. That framework includes open capital markets, the rule of law and intellectual, political and cultural freedom.

Infiltration, surveillance and sabotage

Foreign acquisitions of critical infrastructure or even acquisitions co-located with such infrastructure could give rise to opportunities for infiltration, surveillance and sabotage that might not otherwise be available to a foreign power. Yet such covert and overt threats exist even in the absence of foreign ownership, and foreign ownership would seem to be an inefficient and costly way of acquiring these capabilities. By comparison, Chinese and Russian government-sponsored hacking and cyber warfare represent more significant security risks, but do not depend on FDI or even a physical

presence in the target country for their effectiveness and can be implemented at very low cost.

The threshold question that needs to be addressed in these cases is the potential for these threats to materialise as a direct consequence of foreign ownership. In many cases, these threats will exist independently of ownership. A careless or poorly governed domestic owner of a critical asset that did not pay attention to security risks could provide opportunities for a foreign power to exploit vulnerabilities without ever making an appearance on the share register of the operating business.

These threats are better addressed by applying security screening to the employees and managers of the entity owning and operating sensitive assets, regardless of whether the entity is foreign-owned or not. Such screening should apply even when the asset is in domestic ownership and control given that security risks can be sourced domestically as well as internationally. Employees of domestically-owned firms can be bribed, blackmailed and otherwise coerced into providing information to foreign intelligence services or sabotaging domestic assets. Ideologically or politically-motivated domestic actors may threaten these assets even without direction from foreign governments. It is the role of domestic intelligence and law enforcement agencies to combat these threats. Resources devoted to screening FDI at the border may be more effectively devoted to domestic counter-intelligence efforts to combat real threats as opposed to apprehended threats that may never materialise.

These potential threats argue either for statutory restrictions on foreign ownership or the creation of lists of critical assets and infrastructure for which ownership might be regulated and subject to special conditions. These obligations should apply equally to domestic or foreign owners given that these threats are often independent of ownership. In the case of extremely sensitive assets, it might be thought desirable to maintain the assets in domestic and even public ownership. It is the nature and quality of the governance of these assets that needs the most scrutiny. While ownership is part of the governance structure, the composition of the share register of the operating entity may not be a good guide to security risks. A change in a foreign ownership stake from five per cent to 20 per cent might trigger the FDI screening process, but in itself does not seem very informative about national security risks.

Australia's regulatory regime for FDI

Australia's regulation of FDI at the border is built around the concept of ensuring that foreign investment is not inconsistent with the 'national interest'. A negative test is applied to foreign acquisitions that fall within the scope of the screening process. The 'national interest' is deliberately left undefined in the Foreign Acquisitions and Takeovers Act 1975,[15] mainly with a view to putting ministerial determinations in relation to foreign acquisitions outside the scope of judicial review. The government does maintain a foreign investment policy designed to give guidance to foreign investors on how the national interest test might be applied in various contexts, although this guidance is indicative only and non-binding on the treasurer as the final decision-maker under the Act.

Successive governments have interpreted the 'national interest' test as incorporating national security considerations, but the concept is a much broader one, taking in competition policy issues, tax considerations, economic and community impacts and the character of foreign investors. The test is much broader in scope than that applied in the United States and applies to a wider range of assets. The screening thresholds vary based on whether Australia has a free trade agreement with the source country and whether the foreign investor is privately or publicly-owned (see Appendix 1).

The national interest test affords the treasurer a broad discretion to reject foreign acquisitions based on a range of criteria with little effective judicial or administrative oversight. This discretion is valuable to politicians, giving them the flexibility to respond to controversial cross-border acquisitions in a way that is politically optimal for them. However, it is a sub-optimal regime from the perspective of investors because of the costly risk, uncertainty and delays the FDI screening process creates, even when transactions are ultimately approved. The treasurer's discretion serves as a lightning rod for special interests, which politicises cross-border transactions caught within the screening framework.

The Shell-Woodside, Chinalco-Rio, SGX-ASX, ADM-Graincorp proposed acquisitions are all examples of major transactions that became politicised and ultimately failed as originally proposed due to the FDI screening process.[16] The Australian government's consideration of Chinalco's proposal to increase its stake in Rio Tinto in February 2008, which was referred to the National Security Committee of federal cabinet by the Rudd government, was widely criticised, highlighting weaknesses in both process and policy.[17] According to the United Nations Conference on Trade and Development, by both value and number of acquisitions, Australia had more cross-border inward and outward merger and acquisition transactions fail for regulatory or political reasons than any other jurisdiction between 2008 and 2012.[18] Australia ranked second only to China in one recent global survey of countries where significant rule of law risks occurred in relation to foreign investment.[19]

National security is explicitly invoked as a criterion for the national interest test in the government's foreign investment policy. The policy states that:

> *The Government considers the extent to which investments affect Australia's ability to protect its strategic and security interests. The Government relies on advice from the relevant national security agencies for assessments as to whether an investment raises national security issues.*[20]

The policy also identifies sensitive sectors that are subject to more rigorous screening, including "defence related industries and activities and the extraction of uranium or plutonium or the operation of nuclear facilities as well as other critical infrastructure". Otherwise, the statutory and non-statutory policy framework gives foreign investors little guidance on how the national interest test might be applied to prospective acquisitions. This creates uncertainty for foreign investors and has generated diplomatic and commercial frictions when the framework has been applied in ways that were not anticipated by foreign governments or investors.

By both value and number of acquisitions, Australia had more cross-border inward and outward merger and acquisition transactions fail for regulatory or political reasons than any other jurisdiction between 2008 and 2012.

Foreign government investors are subject to automatic scrutiny in situations where private investors are not. However, foreign government ownership may not be a good guide to whether an acquiring firm poses national security risks. A privately-owned foreign company might still be responsive to demands from its home government or be compromised in other ways. For example, concerns have been raised over the privately-owned Chinese telecommunications company Huawei and the links of its founder to China's People's Liberation Army. China's government mandates cooperation with the state and its security services through its national security laws. These concerns resulted in Huawei's exclusion by the Australian government from supplying equipment to Australia's National Broadband Network.[21] Huawei may also be precluded from participating in the development of Australia's 5G network. It is worth noting that an extensive US government security review of Huawei failed to find evidence of Huawei facilitating Chinese espionage.[22] A widely-cited US congressional report identifying Huawei as a security risk was also criticised for its lack of substance.[23] However, both the Australian and US governments remain concerned about security risks from Huawei.

There are also statutory restrictions on foreign ownership of some assets, including banks, airports, shipping and the telecommunications company Telstra. These ownership restrictions are motivated by both economic and security concerns. Recently, the Australian government has flagged electricity generation, transmission and distribution assets as critical infrastructure potentially attracting special ownership restrictions or other conditions to be evaluated on a case by case basis.[24] However, this merely confirmed what was already evident from government decisions in relation to Ausgrid that had previously caused confusion (see case study in Appendix 2).

The role of Australia's Foreign Investment Review Board

The Foreign Investment Review Board (FIRB), with a secretariat located within Treasury, advises the treasurer on foreign investment decisions, although this advice is not binding in exercising the treasurer's powers to reject foreign acquisitions. FIRB in turn takes advice from other government departments, including national security agencies. Recently, there has been an effort to elevate security considerations within FIRB, including through the appointment as FIRB chairman of David Irvine, AO, a former director general of the Australian Security and Intelligence Organisation (ASIO) and the Australian Secret Intelligence Service (ASIS), Australia's domestic and foreign spy agencies respectively.

More recently, there has been a whole-of-government effort to identify critical infrastructure and improve its resilience through the creation of a Critical Infrastructure Centre (CIC) in the Home Affairs portfolio, which now includes Australia's intelligence agencies. This effort is supported by new legislation, the Security of Critical Infrastructure Act 2018, which seeks to "manage the complex and evolving national security risks of sabotage, espionage and coercion posed by foreign involvement in Australia's critical infrastructure".[25] The Act implements a critical infrastructure assets register and gives the minister a last resort power to mitigate national security risks through directions issued to the owner or operator of critical infrastructure. The CIC is designed to complement the work of FIRB and is part of a broader consolidation of national security processes within government under the Home Affairs portfolio.[26]

The CIC is a welcome development in that it potentially brings a more systematic approach to government policy consideration of assets that might be the subject of potential foreign acquisitions and that raise national security concerns. The legislation does not, however, offer much by way of additional certainty for foreign investors, with the register of critical assets not in the public domain. The last resort power is also welcome and provides greater reassurance that critical infrastructure can be placed in foreign ownership without compromising national security.

Photo: Getty

Reforming Australia's FDI screening process to improve national security

The FIRB process has often lacked transparency to foreign investors, sometimes appearing arbitrary and capricious in its operation and sending mixed signals. FIRB officials have struggled to communicate the government's foreign investment policy in clear and consistent ways, implying the policy was not well-defined, even within government.[27] The information and data publicly supplied by FIRB has been inadequate in helping the government, parliament and the public understand the process and the nature of foreign investment in Australia.

> The government's discretion to reject foreign investment applications should be exercised only in relation to national security issues or cases where domestic regulatory frameworks are unable to address policy issues raised.

A number of proposals have been made to reform the FDI screening and approval process in Australia.[28] The aim of these proposals is to create a non-discriminatory regulatory framework that provides predictability and certainty for both foreign investors and vendors of Australian assets, enhances Australia's reputation as an investment destination and maximises FDI inflows while also securing Australia's security interests.

Narrowing the national interest test

The scope of the national interest test should be narrowed to cover only threats to national security. The concept of the 'national interest' should not be trivialised by associating it with issues that are not genuinely national in scope or of vital strategic concern. The national interest test should not be used as an arm of domestic competition, industry or employment policy or serve protectionist objectives such as preventing the offshoring of head office jobs. Nor should it be thought of as a second-best approach to fill gaps or fix problems created by regulatory failure in other areas of public policy such as housing or taxation. These issues should all be addressed behind the border on a non-discriminatory national treatment basis using domestic regulatory frameworks. FIRB already largely defers to domestic regulators in its consideration of these non-security related economic and other policy issues. Enforcement of restrictions on foreign investment in real estate, for example, is now largely the responsibility of the Australian Taxation Office.

FIRB's primary focus should be consideration of the implications of foreign acquisitions for national security in conjunction with the new Critical Infrastructure Centre. This change would broadly align the mandate of FIRB with that of CFIUS in the United States. Better integrating national security into the FIRB process is a significant challenge that is made more difficult by the government's foreign investment policy, which includes a laundry list of non-binding policy considerations FIRB must consider and make recommendations on. National security and economic policy issues are not easily reconciled given that national security risks and economic costs and benefits are fundamentally incommensurable as considerations for policy. However, where national security is genuinely threatened, these considerations should dominate economic ones.

The multiple policy considerations that form part of Australia's foreign investment policy only serve to expand the scope of the treasurer's discretion over FDI and make for confusion in articulating government policy. Narrowing the scope of the national interest test to national security and delegating other policy issues to post-establishment, behind the border regulation would sharpen the focus of Australia's foreign investment framework and elevate national security concerns above domestic policy issues.

FIRB should develop broad principles for assessing national security risks and make these principles publicly available. The principles should be suitable for multilateral adoption in free trade agreements and investment treaties. The processes to be followed in applying these principles should be the subject of a publicly available guidance note. In the United States, there is a statutory list of security issues that inform

the CFIUS screening process and a publicly-available government guidance document.

FIRB should consider foreign acquisitions based on a threat framework similar to that proposed by Moran and discussed earlier in this report. This would require an overhaul of FIRB to bring in more expertise from the defence and intelligence community at the expense of its current focus on other policy issues that largely duplicates or second-guesses the work of domestic regulators. FIRB should report to the National Security Committee of cabinet rather than the treasurer to ensure a whole-of-government consideration of national security issues.[29]

The government's discretion to reject foreign investment applications should be exercised only in relation to national security issues or cases where domestic regulatory frameworks are unable to address policy issues raised. Decisions to reject particular transactions should be carefully explained in terms of publicly-available principles and the guidance document. The principles could be harmonised with those used by CFIUS with a view to encouraging their adoption on a multilateral basis and inclusion in free trade agreements and bilateral investment treaties (BITS). Existing agreements often include a national security exception. The principles should govern how the national security exception is interpreted and should aim for a narrow construction that addresses only vital security interests.

The screening process should also seek to examine ways in which security risks can be remediated or otherwise addressed without necessarily rejecting the proposed transaction in its entirety. This may entail specific assets or operations being carved out of a proposed transaction, enhanced governance or security screening requirements. Specific assets may be brought within the scope of the recently legislated last resort power. FIRB should aim to facilitate transactions rather than serving as a bureaucratic roadblock to foreign acquisitions.

Based on the CIC's Critical Infrastructure Asset Register, assets deemed too sensitive to allow foreign ownership should be identified either through statutory restrictions on foreign ownership or a negative list to increase certainty for foreign investors and ensure there is public scrutiny and debate around the content of the negative list.

The adoption of clear principles and processes for evaluating transactions reduces the risk that national security issues are conflated with other issues or used to serve domestic political and economic agendas that are not related to genuine security concerns. This would support stronger, more reliable and better understood foreign investment decisions by government. A well-defined and transparent process should deter acquisitions that raise security concerns from being proposed in the first place and investment proposals are more likely to be structured to satisfy the Australian government's concerns.

FIRB could also improve its reporting to parliament. FIRB currently produces an annual report that is neither timely nor particularly informative. A process should be put in place to enable FIRB to brief a parliamentary committee in private on its consideration of national security issues in a way that protects classified and commercially-sensitive information that might not otherwise be made public, with a view to improving parliament's understanding of the foreign investment review process. By helping parliamentarians understand how the FDI screening process protects national security, it is less likely that cross-border acquisitions will become politicised based on an ill-informed understanding of the review process or the relevant security issues on the part of politicians and the public.

The US regulatory regime for FDI

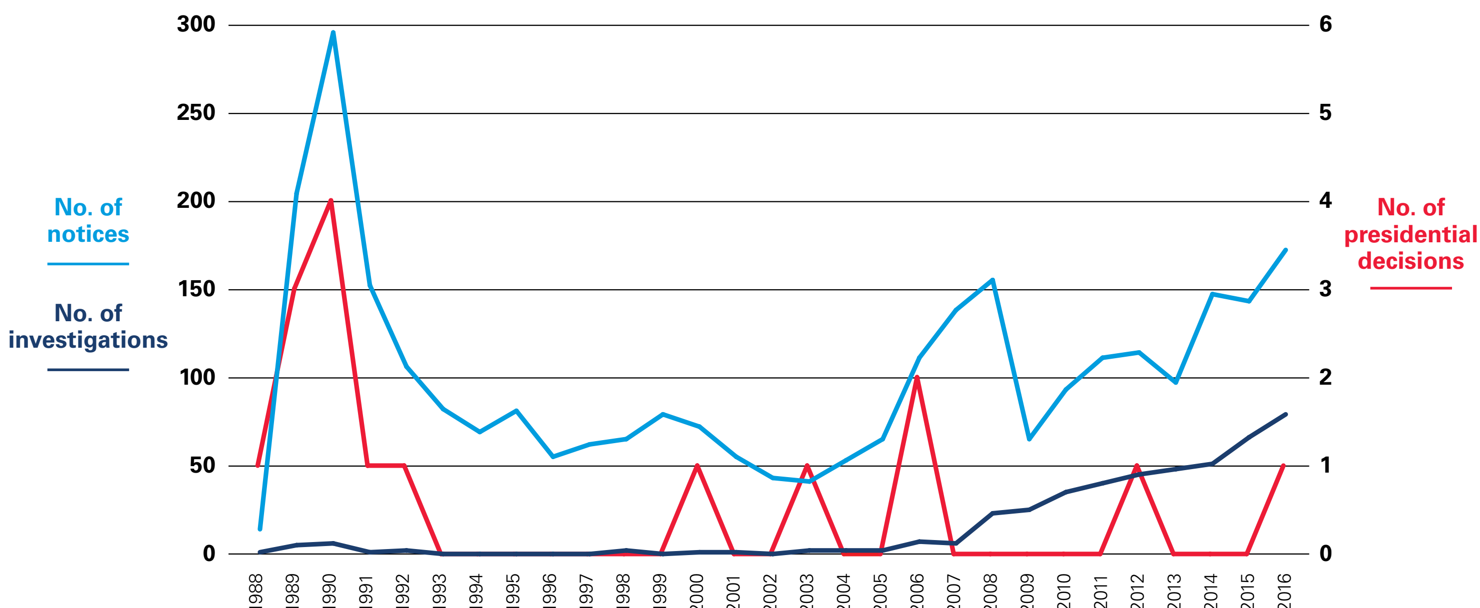
The Committee on Foreign Investment in the United States (CFIUS) is the inter-agency body charged with reviewing any merger, acquisition or takeover that would result in foreign control of a US business to determine the effect on the national security of the United States.[30] It is chaired by the secretary of the Treasury, and includes secretaries from the departments of Homeland Security, Commerce, Defense, State, and Energy; the offices of the US Trade Representative and Science and Technology Policy; and the Attorney General. The secretary of labor and the director of national intelligence serve as ex-officio members to the committee; while five other executive offices — Office of Management and Budget, Council of Economic Advisors, National Security Council, National Economic Council, and Homeland Security Council — can also observe and participate in the CFIUS process. While CFIUS filings are voluntary, the committee may also initiate a review if it determines the transaction could raise national security concerns.

Following a review, if CFIUS finds the transaction does not present any national security risks, or that other laws provide adequate and appropriate authority to address the risks, CFIUS will conclude its review and provide 'safe harbour', meaning the transaction will not be subject to future review. CFIUS will not conclude action on a transaction if there are unresolved national security concerns identified by any CFIUS member. If CFIUS finds that a transaction presents national security risks and that other provisions of law do not provide adequate authority to address such risks, CFIUS may enter into an agreement with, or impose conditions on, parties to mitigate such risks; or it may refer the case to the president for action including a recommendation to block the transaction.[31]

The most recent annual CFIUS report to Congress shows an upward trend in the number of notices filed with CFIUS, from 65 in 2009 to 172 notices in 2016 (see Figure 1). During 2016, only one transaction was subjected to a presidential decision. In terms of the acquirer home country, the report shows that acquisitions by investors from China accounted for the largest share of notices filed for the three-year period from 2013-2015, representing 74 of the total of 387 filings over this period. Investors from Canada, the United Kingdom and Japan accounted for 49, 47, and

Figure 1: CFIUS number of notices and investigations

Source: CFIUS Annual Report



40 transactions, respectively, over the same three-year period. Together, these four countries accounted for more than half (54 per cent) of CFIUS reviewed filings over this period.

The number of CFIUS filings continues to rise: the committee reviewed a record 172 notices in 2016 versus 143 notices in 2015 and nearly 240 notices in 2017, another record. At the same time, the number of filings requiring full investigations has increased, from just four per cent of filings in 2007 to 46 per cent in 2016 and 70 per cent in 2017. Also, the percentage of notices withdrawn during the CFIUS review process has increased from eight per cent in 2014 up to 16 per cent in 2016. The increased caseload, in combination with a more complicated threat environment as detailed below, has intensified CFIUS' scrutiny of transactions and extended the typical CFIUS process timeline.

The increased scrutiny applied to foreign direct investment in the United States is evident in the increased ratio of investigations to notices since 2008 (see Figure 2).

An evolving threat

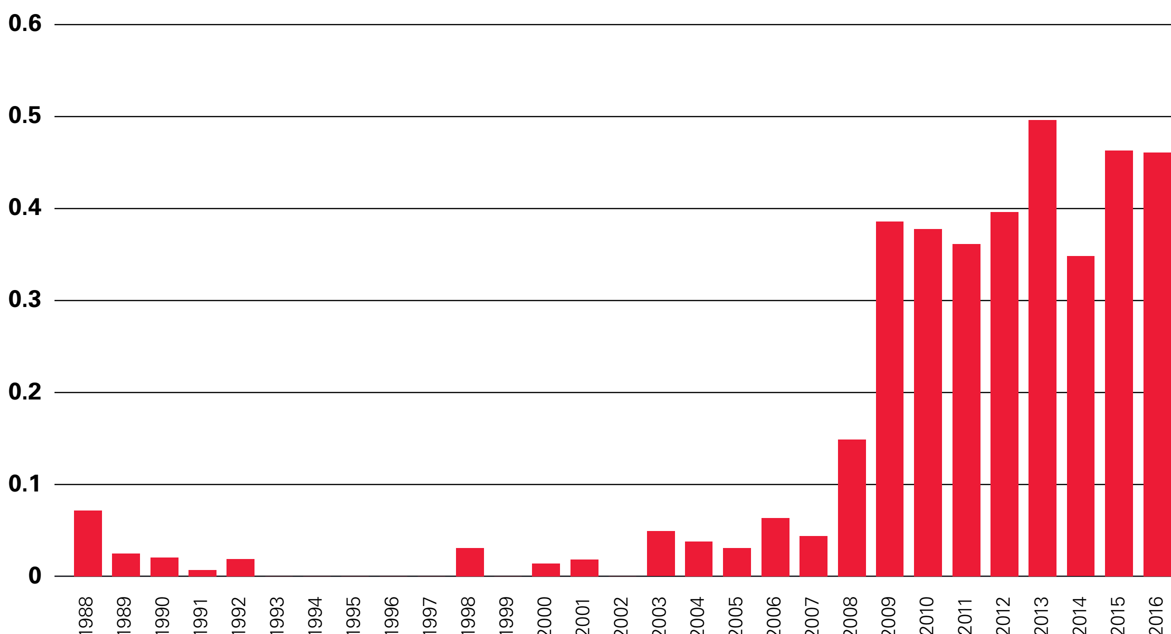
The increase in CFIUS filings as well as the increase in percentage of those filings that advance to full investigations is attributed to a range of factors. In testimony before the Senate Committee on Banking, Housing, and Urban Affairs in early-2018, Heath Tarbert (Treasury's assistant secretary for international markets and investment policy) said the increased complexity confronting CFIUS is attributable to three key factors: First, foreign governments are using investments for strategic, rather than economic, goals; second, transaction structures are increasingly complex; and third, supply chains are increasingly globalised.[32] He also noted the role of data and dual-use technology in contributing to the increasing complexity of transactions reviewed by CFIUS.

China's rise

While CFIUS legislation does not name specific countries of concern, the CFIUS report to Congress highlights the committee's coverage of transactions

Figure 2: Ratio of CFIUS notices to investigations

Source: CFIUS Annual Report, author's calculations



where the acquirer is ultimately controlled by a foreign government; is from a country with a record on "national security-related matters that raise concern"; has a history of taking or intentions to take actions that could impact US national security; and has a history of doing business in sanctioned countries. In that context, the first National Security Strategy (NSS) of the Trump administration flags China (along with Russia) as challenging "American power, influence and interests, attempting to erode American security and prosperity" and refers to some actors' use of "largely legitimate legal transfers and relationships to gain access to fields, experts, and trusted foundries that fill their capability gaps and erode America's long-term competitive advantages".[33]

The more combative stance toward China coincides with a dramatic increase in the stock Chinese FDI in the United States. Just ten years ago, the stock of Chinese direct investment in the United States — which represents the cumulative value of annual investment flows — totalled US$3 billion; by 2017, the stock of Chinese FDI in the United States was valued at US$138 billion,[34] making China the 11th largest foreign direct investor in the United States. On a stock basis, the largest direct investors in the United States are the United Kingdom, Canada, Japan, and Germany, all US allies and countries covered by Collective Defense Arrangements with the United States.[35] China's increasing investment in the United States represents the first time that a top investor in the United States is also considered — according to the NSS — a strategic adversary committed to shaping "a world antithetical to US values and interests".

Photo: Getty

Suspicion of China and its motives in expanding economic ties with the United States did not start in the current US administration. In 2012, two separate congressional reports highlighted the potential national security threats posed by Chinese investment. The first, an October 2012 report from the House Permanent Select Committee on Intelligence, detailed "the counterintelligence and security threat posed by Chinese telecommunications companies doing business in the United States" and called on CFIUS to block acquisitions, takeovers, or mergers involving two Chinese telecommunications equipment companies, Huawei and ZTE, given the threat of these companies specifically to US national security interests.[36] A second report published in November 2012 by the US-China Economic and Security Review Commission raised concerns about the "potential economic distortions and national security concerns arising from China's system of state-supported and state-led economic growth" and that state-backed Chinese companies may decide to invest "based on strategic rather than market-based considerations". This report called for amendments to CFIUS, proposing (1) mandatory CFIUS reviews of all controlling transactions by Chinese state-owned and state-controlled companies wanting to invest in the United States; (2) a net economic benefit test to the current national security test that CFIUS conducts; and (3) a ban on investment in a US industry by a foreign company whose government does not allow foreign investment in that same industry.

Critical and 'dual-use' technologies

CFIUS defines critical technologies, with reference to US Export Control regulations, as (a) defence articles or defence services covered by the munitions list set forth in the International Traffic in Arms Regulation;

(b) items on the Commerce Control List of the Export Administration Regulations that are controlled pursuant to multilateral regimes, for instance missile technology; (c) items and technology specified in the Assistance to Foreign Atomic Energy Activities and the Export and Import on Nuclear Equipment and Materials regulations; and (d) agents specified in the Select Agents and Toxins regulations.[37] However, much of the current debate around the threat posed by foreign investment in critical technologies pertains to the adequacy of the above list to capture emerging critical technologies that may not have existed at the time the regulations were drafted.

In addition, some of the transactions reviewed by CFIUS involve advanced technologies that may (presently or eventually) have both commercial and military applications, so-called 'dual-use' technologies. The CFIUS report to Congress highlights that transactions involving such dual-use applications, as well as transactions that might entail a loss in US technological competitiveness that would be detrimental to national security, are among the considerations covered in reviews undertaken by CFIUS.

A heightened concern regarding advanced technology transfer to China has been evident in recent years, including in the CFIUS process. President Obama's December 2016 decision to prohibit the acquisition of the US business of Aixtron, a German firm with assets in the United States, by a Chinese investment firm; and in President Trump's September 2017 action to block the acquisition of Lattice Semiconductor Corporation by another Chinese investment firm, Canyon Bridge Capital Partners present two recent (and public) examples. President Trump's action in March 2018 to block the acquisition of Qualcomm by the Singapore-based Broadcom was also motivated by concerns of future technological competitiveness (see Appendix 2).

A further aspect to the debate concerns the government's ability to identify ex-ante those technologies and transactions that may pose a threat to national security. In this context, a 2017 draft report by the Defense Innovation Unit Experimental (DIUx) details China's efforts to attain global leadership in emerging technologies such as artificial intelligence, robotics, and augmented reality/virtual reality and financial technology. The DIUx report makes the case that in order to effectively mitigate the potential threat to national security posed by China's ambitions, CFIUS should be reformed, including by upgrading a Department of Defense (DoD) critical technologies list and making the DoD list the basis for CFIUS reviews (as well as export controls); restricting investments and acquisitions by China in these critical technologies; and expanding CFIUS's jurisdiction to cover all transaction types (e.g., greenfield investments and joint ventures, whether located in the United States or abroad).

An October 2012 congressional report detailed "the counterintelligence and security threat posed by Chinese telecommunications companies doing business in the United States" and called on CFIUS to block acquisitions, takeovers, or mergers involving two Chinese telecommunications equipment companies, Huawei and ZTE.

Transaction structure

Increasingly complicated transactions structures may obscure the true ownership of the investing party and/or be designed to get around the concept of 'control' that is fundamental to CFIUS jurisdiction, e.g., licensing and contracting arrangements. Treasury officials have confirmed that CFIUS is aware that some transactions may be deliberately structured to avoid CFIUS review, while others are moving critical technology and associated expertise from a US business to offshore joint ventures. While this issue is relevant to the current discussion of CFIUS's ability to address evolving threats to national security, it is not new. In fact, as originally drafted, the 1988 Exon-Florio amendments to CFIUS would have applied to joint ventures and licensing agreements in addition to mergers and acquisitions. But joint ventures and licensing agreements were ultimately dropped from the legislation because the Reagan administration and various industry groups argued at the time that such business practices were deemed beneficial for US companies. In addition, they argued that any potential threat to national security could be addressed by the Export Administration Act and the Arms Control Export Act.[38]

Greenfield investment

The DIUx report and others point to the increasing role of start-up or 'greenfield' investment by China, particularly in venture capital, to provide China with access to cutting-edge technologies. While China is the primary source of this concern, concerns around greenfield investments falling outside CFIUS jurisdiction first gained prominence following the attempt by the Russian space agency, Roscosmos, to build Global Positioning System (GPS) monitor stations in the United States in 2013. This episode generated interest in amending CFIUS's jurisdiction to include greenfield investments, a recommendation that has gained additional traction because of the perceived threat stemming from Chinese investment.

Data concerns

The 2018 decision by China's Ant Financial to abandon its bid to acquire MoneyGram International after failing to get CFIUS approval increased the profile of digital data and its possible national security implications (see Appendix 2). While the US government did not officially confirm that data were at the heart of national security concerns related to the transaction, at least one media outlet's reference to congressional concerns that "approving Ant's purchase of MoneyGram might allow 'malicious actors' to get hold of financial data belonging to American soldiers and their families" shed light on CFIUS' assessment of the intersection between digital data and national security. While data and data analytics have been integral to national security analysis for decades, the full scope of data's relevance to national security, including in the context of foreign investment, is raising questions about how governmental authorities should respond to the potential national security risks posed by access to data as well as the data itself.

Proposed CFIUS reforms

The evolving nature of the potential national security threats stemming from foreign direct investment has led to multiple legislative proposals in the US Congress that aim to close perceived gaps in the current CFIUS regime.[39] The broadest proposal, known as The Foreign Investment Risk Review Modernization Act of 2017 (FIRRMA), was introduced in both houses of Congress on 8 November 2017, in companion bills sponsored by Republican Representative Robert Pittenger (H.R. 4311, with 18 co-sponsors) and Republican Senator John Cornyn (S. 2098, with 10 co-sponsors). This legislation represents the most comprehensive reform of the foreign investment review process under CFIUS since the 2007 enactment of FINSA. The Trump administration has also given consideration to blanket restrictions on investment in certain sectors invoking the International Emergency Economic Powers Act 1977.

Left unchanged in FIRRMA are provisions that effectively serve as the core principles of the CFIUS process. The first provision states that CFIUS can proceed into the national security investigation phase only after it has determined during the national security review phase that a foreign investment transaction (1) threatens to impair the national security of the United States; (2) is controlled by a foreign government; or (3) would result in foreign control of any critical infrastructure that would impair the national security of the United States and that the impairment had not been satisfactorily mitigated.

Currently, parties to a transaction provide a voluntary notification to the committee. Under FIRRMA as initially drafted, CFIUS would require a written notification of a transaction in certain cases due to (1) the technology, industry, economic sector, or economic subsector of the US business being acquired; (2) the difficulty involved in remedying the harm to national security caused by the investment transaction; and (3) the difficulty involved in obtaining information on the transaction. FIRRMA would also expand the scope of CFIUS review to include any investment in a US critical technology or a critical technology infrastructure.

FIRRMA as initially drafted would add nine factors to the existing factors the committee and the president may choose to use in evaluating the implications of an investment transaction on US "international technological and industry leadership".[40] This would be a departure from the traditional focus on national security more narrowly defined. Furthermore, FIRRMA would require greater scrutiny by CFIUS of transactions from countries of 'special concern' that involve critical technologies or critical materials, including review of firms that provide services or support to entities that are associated with critical technologies or industries.[41] Another provision of FIRRMA would strengthen information-sharing with US partners such as Australia and create a 'safe list' of certain allied countries, for which these new types of transactions would be exempt from review.[42]

> The Foreign Investment Risk Review Modernization Act has been the subject of numerous congressional hearings and received the vocal support of the Trump administration and multiple Committee on Foreign Investment in the United States agencies, including Treasury.

FIRRMA has been the subject of numerous congressional hearings and received the vocal support of the Trump administration and multiple CFIUS agencies, including Treasury as the CFIUS chair. Certain elements of the legislation have earned near universal support, for instance, the proposal to increase resources allocated to CFIUS agencies in order to keep pace with the increasing number and complexity of transactions to be reviewed by CFIUS; providing CFIUS with jurisdiction over real-estate transactions near military bases or other sensitive government facilities; and making the CFIUS review process mandatory for certain transactions, including those that involve government ownership.

Other proposals included in the draft legislation have received broad support in theory, but observers are sceptical that proposed reforms can adequately address the risk. One example is the proposal to define the list of critical technologies that would be evaluated in the context of a CFIUS review (also relevant to export controls). While there is broad agreement on the need to update the critical technology list, there

is widespread scepticism regarding the government's ability to update the list in a meaningful way given that future applications of emerging technologies cannot be known. Similarly, while there is support for differentiating CFIUS reviews depending on the source of the FDI, the basis for such differentiation is under debate. On increased information sharing among 'like-minded' countries, there are questions around how to define a 'like-minded' country and how to share information, including information shared on a confidential basis by private-sector entities.

In a move that was likely not a coincidence, House Foreign Affairs Committee Chairman Ed Royce and ranking member Eliot Engel in February 2018 introduced bipartisan legislation, *H.R. 5040, the Export Control Reform Act of 2018*, as an attempt to modernise US export control regulations of dual-use items. This bill would repeal the lapsed Export Administration Act (EAA) and replace it with a permanent statutory authority to better administer US dual-use and Department of Commerce-licensed military exports. It also stipulates that export controls guarantee enduring US leadership in science, technology, engineering, manufacturing and other such sectors. Also, it provides new authority to classify and appropriately regulate emerging critical technologies. Finally, the bill is an attempt to support US diplomatic efforts to advocate for greater international coordination and cooperation on export controls.[43]

As of this writing, the prospects for both the FIRRMA and export control legislation remain uncertain, though most analysts expect some version of both bills to eventually be enacted by Congress. Ultimately, it is the implementation of CFIUS — through regulations and presidential action — that may have the greatest bearing on how foreign investment reviews are conducted, notwithstanding any changes to the actual legislation.

Increased coordination between Australia and the United States

Photo: Darwin Harbour (Getty)

The acquisition of the Port of Darwin by the Chinese-owned Landbridge in 2015 became a point of diplomatic friction between Australia and the United States, as much due to a lack of consultation on the transaction and the screening process as the substance of the transaction itself, although specific national security concerns were also raised (see Appendix 2).

This episode argues for a more formal consultative process between Australia and the United States on foreign acquisitions that raise national security concerns. Both Australia and the United States source information from their own intelligence agencies as part of their FDI screening processes. There is already extensive cooperation between US and Australian intelligence agencies through the 'Five Eyes' intelligence sharing arrangements, however, FIRB and CFIUS have not traditionally been strong repositories of national security expertise.

A memorandum of understanding between the Australian and US governments could be used to formalise cooperation between the two bodies. The FIRRMA Bill before Congress envisages increased cooperation with allied countries on these issues. This would complement existing 'Five Eyes' processes in relation to intelligence sharing. This argues for the creation of an improved capability within FIRB and CFIUS to handle classified information and process it in a way that integrates national security concerns with other elements of the FDI screening process. The more the screening process deviates from narrow security concerns, the more difficult this integration process becomes.

It is possible to imagine situations in which a cross-border acquisition affects assets in both Australia and the United States that raise national security concerns. This scenario may call for a joint FIRB-CFIUS review and a coordinated approach to either remediating or rejecting the transaction. Given the often shared and collaborative nature of defence industry development between Australia and the United States, a joint and coordinated approach to protecting technology from appropriation through foreign direct investment makes sense.

Conclusion

The negotiations over the Australia-US Free Trade Agreement (AUSFTA) nearly failed over US opposition to Australia's foreign investment screening regime. One of the top US negotiating priorities was in fact the elimination of FIRB, which the United States correctly saw as a vehicle for Australian government protectionism rather than promoting national security.[44] The agreement was successfully concluded in 2004 only after Canberra agreed to raise and rationalise its FDI screening thresholds. The AUSFTA set a benchmark for liberalisation of Australia's screening thresholds that has since been adopted in Australia's FTAs with other countries and in the context of the Trans-Pacific Partnership. The United States has thus been a force for liberalisation in Australia's foreign investment regulatory framework.[45]

There is still much that Australia can learn from the United States in the regulation of foreign investment. The United States maintains a more liberal regulatory framework for FDI that is better focused on national security issues than the Australian process. CFIUS administers a set of statutory principles in relation to national security considerations that could be adapted by FIRB in its scrutiny of foreign investment applications. To date, the United States has resisted giving CFIUS a mandate to consider broader economic policy issues that are more appropriately addressed behind the border by domestic regulatory frameworks.

It is important to focus scarce regulatory resources on genuine risks to national security and not be distracted by the second-order policy issues that have proliferated in the Australian government's foreign investment policy.

The United States and Australia have struggled to re-define their approach in response to the national security issues raised by China's increased role in foreign investment and the relationship of that investment to its mercantilist industrial policies and increasingly assertive military posture. In this environment, it is important to focus scarce regulatory resources on genuine risks to national security and not be distracted by the second-order policy issues that have proliferated in the Australian government's foreign investment policy. These non-security related policy considerations largely duplicate or second-guess domestic regulatory frameworks that already operate behind the border to regulate business investment. Screening acquisitions at the border based on these policy considerations adds little that is useful to the regulation of business investment in Australia and provides a vehicle for political interference in cross-border transactions that is mostly detrimental to Australia's reputation as a reliable destination for foreign investment.

The principle that the economic regulation of FDI is best implemented behind the border also applies to national security regulation. National security needs to be achieved behind the border over time and not at the border at a particular point in time. Blocking transactions at the border may give a false sense of security in relation to risks behind the border that may arise independently of foreign ownership. Addressing these risks is a task for domestic law enforcement, security and intelligence agencies. Better resourcing of those agencies would do more to secure Australia's vital national interests than additional resources devoted to screening foreign acquisitions that for the most part do not represent national security risks.

Policy recommendations

- The Committee on Foreign Investment in the United States (CFIUS) provides a useful model for how Australia could reform its foreign investment screening process to better focus on national security issues, while leaving other non-security policy issues to domestic regulatory frameworks behind the border.
- The government's discretion to reject foreign investment applications should be exercised only in relation to national security issues or cases where domestic regulatory frameworks are unable to address policy issues raised.
- Australia's Foreign Investment Review Board (FIRB) should be overhauled to better integrate consideration of national security and critical infrastructure issues. FIRB should report to the National Security Committee (NSC) of federal cabinet rather than the treasurer on national security issues. The NSC should be the decision-making authority rather than the treasurer.
- The Australian government should develop broad principles for assessing national security risks and make these principles publicly available. The principles should be suitable for multilateral adoption in free trade agreements and investment treaties. The process for applying these principles should be articulated in a publicly-available government guidance document.
- Critical infrastructure and other assets deemed too sensitive to allow foreign ownership should be identified either through statutory restrictions on foreign ownership or a negative list to increase certainty for foreign investors.
- FIRB should improve its reporting to parliament, including through confidential hearings to parliamentary committees to protect classified and commercially sensitive information.
- A memorandum of understanding should be signed between the Australian and US governments for the exchange of information and setting out procedures for consultation and the joint consideration of cross-border acquisitions that raise common national security issues. This would complement existing 'Five Eyes' processes in relation to intelligence sharing.

Appendix 1: Comparison of FDI screening and approval processes, Australia and the United States

	AUSTRALIA	UNITED STATES
Legislation	■ Powers granted under the Foreign Acquisitions and Takeovers Act 1975, the Foreign Acquisitions and Takeovers Fees Impositions Act 2015, and associated regulations. ■ Amended in 2015 to provide new penalties, application fees and lower thresholds for agricultural land. ■ Further amended in 2016 to allow review of non-government foreign investors acquiring an interest in critical infrastructure assets.	■ CFIUS was established in 1975 by Executive Order 11858 (Foreign Investment in the United States) and codified in the 1988 Exon-Florio amendment to the Defense Production Act of 1950. The current CFIUS process reflects changes made in the Foreign Investment and National Security Act of 2007.
Mandate	■ Whether a foreign investment is contrary to Australia's 'national interest'.	■ Whether a foreign investment 'threatens to impair the national security of the United States'.
Scope	■ The regime reviews foreign governments, and their entities, acquiring a direct interest (generally at least 20 per cent), and non-government foreign investors acquiring a substantial interest (generally at least 20 per cent) above certain thresholds. ■ The framework also covers any acquisitions of critical state-owned infrastructure relevant to national security, as well as residential, commercial and agricultural land.	■ Mergers, acquisitions, or takeovers that result in foreign control of a US business. This can include minority investments that confer a significant ability to influence 'important matters' related to the US business.
Process and fees	■ Foreign investors are required to lodge applications electronically with FIRB. *General fees* ■ Transactions of A$10M or less: A$2,000 ■ Transactions A$10M-$1B: A$25,300 ■ Transactions greater than A$1B: A$101,500 More details at http://firb.gov.au/resources/guidance/gn30/.	■ Companies are not required to notify CFIUS of a transaction, but CFIUS has the authority to review transactions that have not been notified. Parties are encouraged to contact CFIUS before making a formal filing and many companies voluntarily file to avoid the risk of CFIUS review later in the acquisition process. ■ No fees.

	AUSTRALIA	UNITED STATES
Key thresholds triggering regulatory review	■ Determined by country, sector, and nature of foreign entity. *Trade agreement countries* ■ Nonsensitive business: A$1,134M ■ Sensitive business: A$261M ■ Media: A$0 ■ Agribusiness: $57M / A$1,134M (depends on country) *Non trade agreement countries* ■ All businesses: A$261M ■ Media: A$0M ■ Agribusiness: A$57M *Foreign government investors* ■ Any foreign government investment starting or acquiring a direct interest in an Australian business: A$0M ■ Investments in property incur various thresholds. More details at http://firb.gov.au/exemption-thresholds/monetary-thresholds/.	■ Any covered transaction that may result in foreign control of a US business, although reporting is voluntary.
Decision-making authority	■ FIRB makes recommendations but the treasurer ultimately decides if an investment is contrary to Australia's national interest. The treasurer can raise no objections, reject an application, or require certain conditions.	■ CFIUS can request a review of transactions and approve, reject, or impose conditions. The president can block an investment if deemed that national security is harmed.
Timeframe	■ Generally, a 30-day review but this process can be indefinitely extended in 90-day increments.	■ 30-day review, then an additional 45 days if CFIUS finds the transaction involves a foreign government. If a report is sent to the president, they have 15 days to make a decision.

	AUSTRALIA	UNITED STATES
Statistics on cases	■ 43,013 cases were considered in 2015-2016, a significant increase from 38,932 in 2014-2015, 25,005 in 2013-14, and 13,322 in 2012-2013. ■ 41,445 cases were approved in 2015-2016, 14,491 of which were approved with conditions. Five cases were rejected while 1,319 cases were withdrawn. More details at https://cdn.tspace.gov.au/uploads/sites/79/2017/04/1516-FIRB-Annual-Report.pdf.	■ Since 2010, between 95-172 cases notified each year, with around a third or less of the cases resulting in investigations. On average, around eight per cent of notices are withdrawn after commencing an investigation. The US president averages less than one decision a year. ■ In 2016, 172 cases were notified, with 79 investigations, and one presidential decision. ■ CFIUS received nearly 250 notices in 2017. More details at https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Unclassified%20CFIUS%20Annual%20Report%20-%20(report%20period%20CY%202015).pdf.

Source: Adapted from UK government's National Security and Infrastructure Investment Review, October 2017

Appendix 2: Case studies

The following case studies highlight some of the issues of policy and process raised by previous foreign investment transactions and help identify the scope for improving the FDI screening process.

Australian case studies

AUSTRALIAN ENTITY: OZ Minerals

FOREIGN ENTITY: China Minmetals Corporation

DATE: 2009

China Minmetals Corporation, a Chinese SOE, sought to purchase OZ Minerals, an Adelaide-based copper and gold mining company for A$2.6 billion. Treasurer Wayne Swan rejected the sale in March 2009 on national security grounds, citing OZ Minerals's holding of the Prominent Hill Mine, which is located within the Woomera Prohibited Area military testing zone in South Australia. The Woomera Prohibited Area is the largest military zone in the world, covering 130,000 square kilometres, or roughly the size of England and is used to test guided missiles, unmanned aerial vehicles and electronic warfare systems. According to journalist David Uren, the transaction was rejected even though:

- China Minmetals Corporation had initially been told by the Australian Defence Department that it had no objections to the sale;
- the Woomera weapons testing zone is 160 km away from the mine;
- the proposal stipulated that the company intended to maintain the OZ Mineral's Australian management and staff; and
- companies operating in military zones are required to allow any military inspection of their location, equipment and personnel at any time.[46]

A revised investment proposal was approved in April 2009 after the Prominent Hill Mine was excluded from the transaction and numerous non-security related conditions were attached to the approval that were explicitly protectionist in intent.[47] There was considerable speculation around the treasurer's motives for blocking the initial acquisition. This speculation points to a lack of clarity about the role of national security in the FDI screening process. The Australian government's security concerns were not well flagged to foreign investors, while the advice the government received seems to have been inconsistent with the foreign investment decision taken.

Photo: Getty

AUSTRALIAN ENTITY:
Ausgrid

FOREIGN ENTITY:
State Grid Corporation and Cheung Kong Infrastructure

DATE: 2016

The Chinese government-owned State Grid Corporation and Hong Kong-based Cheung Kong Infrastructure were bidders for a 99-year lease over a 50.4 per cent stake in New South Wales electricity distributor Ausgrid in a sale that was expected to be worth around A$10 billion to the state government.

The deal was rejected at the last minute by the federal treasurer, citing national security concerns, a decision that had bipartisan political support at the federal level. The decision came as a surprise given that the sale process had proceeded to an advanced stage before the foreign investment decision was made, with bidders having previously been given a green light from the federal government. State Grid operates electricity infrastructure globally and elsewhere in Australia. The government did not elaborate on the national security concerns at the time of the transaction.[48]

It has since been revealed that at the last minute the Australian Signals Directorate identified that Ausgrid hosts infrastructure supporting the Australia-US Joint Facility at Pine Gap, part of the US strategic nuclear early warning system and also an essential element of Australia's intelligence gathering.[49] The late identification of this security issue exposed weaknesses in the foreign investment review process, in particular, which federal government department was responsible for critical infrastructure. This episode became part of the impetus for the formation of the Critical Infrastructure Centre.[50] It also informed changes to the government's foreign investment policy to specifically flag electricity-related assets as critical infrastructure likely to give rise to increased scrutiny and special conditions for foreign acquisitions.

AUSTRALIAN ENTITY:
Northern Territory Government/
Port of Darwin

FOREIGN ENTITY:
Landbridge Corporation

DATE: 2015

The Landbridge Corporation, a privately-owned Chinese company, purchased a 99-year lease over the Port of Darwin from the Northern Territory government for A$506 million. Because the vendor was a territory government, the transaction was not subject to the usual scrutiny from the Foreign Investment Review Board, a loophole that has since been closed.

The sale, at least initially, raised no objections from the Australian Defence Department, although its consideration of the transaction only encompassed the issue of maintaining access for the Australian Defence Force, not wider security concerns. The US government was surprised and reacted adversely due to a lack of consultation by the Australian government. The port's proximity to Australian and US forces based in Darwin, as well as a sensitive communications cable, potentially raises national security issues, in particular, whether Chinese ownership could facilitate intelligence collection on the deployment of Australian and US forces.[51]

The transaction was the subject of an Australian senate inquiry that exposed significant weaknesses in the way in which national security considerations were addressed by the Australian government.[52] Whatever the merits of the security concerns raised by the acquisition, these issues were only seriously considered and debated after the transaction was announced. The Port of Darwin case also points to a failure of consultation between Australian and US authorities, highlighting the need for greater coordination on these issues. This episode highlights the need for security considerations to be elevated and better integrated into the FIRB process, as well as better consultation with the United States.

AUSTRALIAN ENTITY:
Cable & Wireless Optus Limited

FOREIGN ENTITY:
Singapore Telecommunications Limited (Singtel)

DATE: 2001

Singtel, a state-owned Singaporean company, sought to purchase Optus, a private UK-owned telecommunications company that was the second largest telecommunications company in Australia, for A$17.2 billion. At the time, the transaction was the second largest corporate deal in Australian history.

A national security issue arose in that Optus-operated satellites used by the Australian Department of Defence. This issue was addressed by Optus agreeing to a number of conditions, including an agreement signed between the Defence Department and Singtel mandating relevant personnel obtain security clearance and that the Australian government could control the satellite networks in the event of a national security emergency. The United States, which supplied the satellite equipment, also gave its approval for the deal by stating that a US export license was unnecessary.

The deal encountered objections from some defence analysts and some in the business community. A mitigating factor was that control was passing from one foreign company to another and these entities resided in countries with which Australia has traditionally enjoyed a close security relationship. Australia was also hoping to expand its already positive relationship with Singapore with a free trade agreement, which was signed shortly after the deal.

This transaction would seem to provide a good model for how the FDI screening process should operate. The security concern was clearly identified and articulated by the Australian government, allowing the parties to the transaction to put in place arrangements that satisfied Australian government concerns, enabling the transaction to proceed. There seems to have been effective coordination with US authorities in this case.

Photo: Getty

AUSTRALIAN ENTITY: Lynas Corporation Limited

FOREIGN ENTITY: China Nonferrous Metal Mining Group

DATE: 2009

China Nonferrous Metal Mining Group, a Chinese State-owned corporation, sought to purchase 51.6 per cent of Australian rare earths producer Lynas Corporation Limited for A$500 million. According to Uren, FIRB had approved the sale but Treasurer Wayne Swan decided to block it after reading a story in the *New York Times* about China's supposed cornering of the international market for rare earths. Swan decided that FIRB did not appreciate these risks and FIRB subsequently sought to limit the sale to 49.9 per cent of Lynas, not the 51.7 per cent the Chinese company was seeking, even after both companies agreed independent directors would control the marketing of rare earths products. This demand led the Chinese firm to withdraw its offer.[53]

According to minutes obtained in a Freedom of Information request, FIRB "concluded that they would not be able to exclude the possibility that Lynas' production could be controlled to the detriment of non-Chinese end users", which would be "inconsistent with the government's policy of maintaining Australia's position as a reliable supplier to all our trading partners and hence potentially contrary to national interest."[54] Treasurer Swan argued the conditions he placed on the sale of rare earths miner Lynas to a Chinese state-owned company was driven by China having a dominant position in rare earths with about 85 per cent of world output. China introduced an export quota system for rare earths in 1999 as a mechanism to ensure domestic demand and reserves are met ahead of exports, a system that was later the subject of a World Trade Organization dispute.[55]

The Lynas case sought to pre-empt a security of supply issue that was only hypothetical and despite the parties to the transaction seeking to put mitigating measures in place. The government appears to have over-ridden the advice of FIRB in the first instance before imposing an ownership limit leading to the failure of the transaction. While China's role in the rare earths market and security of supply is an issue globally, the decision in this case does not appear to have been based on sound analysis of the rare earths market. It is always open to the Australian government to impose export controls to address security of supply issues and this would seem to be a preferable approach to blocking foreign acquisitions.

Photo: Getty

US case studies

AMERICAN ENTITY:
Aixtron

FOREIGN ENTITY:
Grand Chip Investment GmbH

DATE: December 2016

On 2 December 2016, President Barack Obama, acting on the recommendation of CFIUS, issued an executive order that prohibited the acquisition of the US business of Aixtron SE ('Aixtron') by a German company with large US operations that was ultimately owned by Chinese investors. This was the first time that a president had formally utilised the authority granted by CFIUS to block a foreign acquisition prior to the consummation of the transaction.

The administration did not offer an account of the national security concerns that formed the basis for its decision to prohibit the transaction. However, the Department of the Treasury did note that "the national security risk posed by the transaction relates, among other things, to the military applications of the overall technical body of knowledge and experience of Aixtron, a producer and innovator of semiconductor manufacturing equipment and technology". The statement noted that Aixtron "manufactures equipment for the global semiconductor industry, including Metal-Organic Chemical Vapor Deposition ('MOCVD') systems used to build compound semiconductor materials", and that the prospective buyer, Grand Chip Investment GmbH, is "ultimately owned by investors in China, some of whom have Chinese government ownership". The statement also indicated that the prospective acquisition would have been funded in part by an industrial investment fund financed by China's government.

Aixtron and the buyer chose to submit a voluntary notice of the transaction to CFIUS. After a national security review, CFIUS denied approval of the transaction and suggested that the president block it.

President Obama's action followed a peculiar series of events, which saw the German Federal Ministry of Economic Affairs and Energy publish a clearance certificate for the transaction pursuant to the provisions of the German Foreign Trade Act and the German Foreign Trade Ordinance. It was issued on 8 September 2016, to China's Fujian Grand Chip Investment Fund LP — the indirect shareholder of Grand Chip Investment GmbH. However, the ministry reversed course and ultimately withdrew the certificate in late October. After the events, the German government made no official statement regarding the withdrawal. However, Deputy Economy Minister Matthias Machnig told German newspaper *Die Welt*, "the federal government has received previously unknown security-related information". Later press reports suggested that US intelligence officials had communicated concern to their German counterparts regarding the possible transaction.

The executive order issued by President Obama in the Aixtron case underscored the scrutiny applied to foreign investments in sensitive US industries, including the semiconductor sector, and particularly when the transaction concerns investment from China. CFIUS has publicly stated that national security concerns can be grounded in the fundamental know-how of individuals within a business, especially in the semiconductor industry with businesses that are engaged in the design and production of equipment related in some part to semiconductor manufacturing or creation.

AMERICAN ENTITY:
Qualcomm Incorporated

FOREIGN ENTITY:
Broadcom Limited

DATE: March 2018

On 12 March 2018 President Donald Trump blocked Singapore-based Broadcom Limited's US$117 billion bid for Qualcomm Incorporated. The move was motivated by underlying concerns about an arms race between the United States and China over advanced technologies. Although Broadcom is based in Singapore, CFIUS said that the bid had the potential to raise issues for the United States' broader technological competition with China. Specifically, it was feared that Broadcom would impede research and development at Qualcomm given its reputation as an organisation known for cutting costs. CFIUS said that such a move had the potential to damage Qualcomm — and thus the United States — against foreign rivals who are vigorously working to develop fifth-generation (5G) wireless technology, such as Huawei Technologies Co. in China.

One of the key concerns that CFIUS expressed about the Qualcomm bid was with regard to Broadcom's "relationships with third party foreign entities and the national security effects of Broadcom's business intentions with respect to Qualcomm". This concern was captured in a highly unusual letter sent by the working-level Treasury chair of CFIUS to the companies' lawyers on 5 March 2018.[56]

CFIUS had also expressed worries about Broadcom's efforts to expedite the relocation of its headquarters to the United States in order to avoid CFIUS scrutiny. CFIUS had alerted the companies' lawyers that Broadcom had allegedly repeatedly breached its order from CFIUS to provide the panel with five days' notice before pursuing its relocation plan. CFIUS also stated that its investigation of the bid had confirmed the national security risks it had identified beforehand with the proposed merger.

CFIUS's decision to review Broadcom's bid came only days before Qualcomm shareholders were going to be voting on whether or not to replace six of the company's 11 directors with nominees put forward by Broadcom; such a result could have helped Broadcom achieve the takeover. Representatives from the departments of Justice, Homeland Security, Defense and Energy had pushed CFIUS to start its review of the deal before Qualcomm shareholders went to vote on the change of directors that included the nominees from Broadcom.[57]

The decision by CFIUS has little precedent. Since the decision, some private-sector lawyers who specialise in CFIUS regulation stated that the committee's decision to interfere in the deal before it was signed — and its rationale for recommending against it, which included concerns over its ramifications for US competition with China — represented an abuse of the committee's powers since its reviews are to focus solely on threats to national security.

AMERICAN ENTITY:
MoneyGram

FOREIGN ENTITY:
Ant Financial

DATE: January 2018

At the beginning of 2018, Ant Financial cancelled its bid to acquire US money transfer company MoneyGram International Inc. after CFIUS rejected the proposed action over national security concerns. At the time, it was the most high-profile Chinese deal to have been annulled under the administration of President Donald Trump.[58]

The deal's demise brought to light increasing concerns in both the United States and China over the sensitivity of personal data. In buying a large-scale money-transfer company like MoneyGram, Ant Financial could potentially have had access to a large number of records of financial flows within the United States. That fact, combined with close ties to China's government, could have created security problems for the United States.[59]

Dallas-based MoneyGram has approximately 350,000 remittance locations in nearly every country in the world. Ant Financial had been looking to acquire MoneyGram not necessarily for its US presence, but rather to expand in growing markets outside China. After the deal fell through, however, Ant Financial and MoneyGram made a public statement that they would explore and develop initiatives to work together in remittance and digital payments in China, India, the Philippines and other Asian markets, as well as in the United States through some form of commercial agreements. Depending on the direction of any CFIUS reform, this kind of arrangement may not be subject to CFIUS review.

Photo: Getty

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