Submission to Productivity Commission Inquiry into Barriers to Services Exports by the Australian Financial Markets Association

15 May 2015

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Summary of Recommendations

AFMA make the following observations and recommendations in its submission.

- The ABS should produce regular surveys of foreign affiliate trade by industry sector and report trade statistics on a value-added basis to more accurately reflect sectoral contributions to exports and the income derived from overseas investments. Consideration should also be given to allowing ABS greater access to data acquired by financial sector regulators such as APRA and ASIC. This would enable ABS to enhance the quality and quantity of data in relation to the financial services sector. This would require some legislative change.
- The inquiry should highlight the implications of Australia's corporate tax rate and international tax rules for Australia's international competitiveness in relation to the export of financial services. The Commission should call for the implementation of those recommendations of the Johnson report that are still outstanding in relation to international taxation arrangements.
- The Corporations Act should be amended to provide the flexibility to permit managed funds to adopt a separation of investment manager from trustee to provide structures more familiar to foreign investors. This means allowing a structure which would have been the norm before 1998 amendments to the Corporations Act.
- The inquiry should reiterate its previous support for a more liberal approach to the regulation of FDI under the Foreign Acquisitions and Takeovers Act. In particular, the Commission should again recommend that 'Australia apply the same notification threshold to all countries in accordance with the WTO's Most Favoured Nation principle. This would involve uniform application of the lower threshold currently applying…under bilateral trade agreements.'
- The inquiry should recommend that the government give the Productivity Commission a reference to conduct a comprehensive inquiry into impediments to cross-border investment and capital flows. Such an inquiry would be a natural complement to the current inquiry into barriers to services exports.
- The Productivity Commission's annual Trade and Assistance Reviews play a valuable role in highlighting the economy-wide costs of domestic trade and industry policies that discriminate against foreign commercial interests at a cost to Australian consumers and producers and may provoke or help justify similar measures on the part of key trading partners. The Commission should work to ensure that these regular reviews have a high public and media profile.
- The Australian government should pay careful attention to the implications of international regulatory initiatives in the areas of prudential and liquidity standards and OTC derivatives reforms to ensure that Australian financial institutions are not placed at a competitive disadvantage internationally.
- The Australian government should use international regulatory fora to promote the mutual recognition of regulatory standards where there is a similar regulatory intent, recognising that regulation needs to be adapted to local conditions.

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- The Commission should note the potential damage domestic and foreign financial transactions taxes (FTTs) can inflict on cross-border trade in financial services and that these taxes are inefficient revenue raisers.
- The Australian government should use its influence internationally to promote flexible exchange rate regimes and open capital accounts. The internationalisation of the Chinese RMB can be facilitated by the Australian government through the promotion of regional trading hubs and bilateral and multilateral currency swap facilities. This in turn can be expected to promote growth in international financial services trade, in much the same way that the floating of the Australian dollar and financial deregulation in the 1980s promoted the development of Australia's financial markets and services exports.
- AFMA note that the bipartisan policy aspiration to promote Australia as a regional and international financial centre has not been matched by the level of policy attention and policy resources devoted to this task.
- There is a lack of policy coordination and role of Treasury in this regard has been impaired by a lack of resources. The lack of follow through in relation to the recommendations of the 2009 Johnson report on *Australia as a Financial Centre: Building on our Strengths* exemplifies these problems.
- The Commission should recommend that the government prioritise the promotion of Australia as a regional financial centre and its integration with regional financial markets. A joint government-industry taskforce along the lines suggested by the Johnson report should be mandated to identify impediments to financial services exports in Australia and abroad and obtain political support for their removal or mitigation.
- AFMA noted in its submissions to the Financial System Inquiry that the government does not appear to have a comprehensive strategy for guiding the future development of the financial system, its role in the Australian economy and its integration with the rapidly growing trade in financial services in the Asia region.
- The Commission should evaluate export assistance and subsidy programs as part of its annual Trade and Assistance Reviews. Where economy-wide costs are found to exceed benefits, the Commission should recommend to government that these programs be wound-up.

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1. About AFMA

The Australian Financial Markets Association (AFMA) was formed in 1986. Today we are the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets – including the capital, credit, derivatives, foreign exchange and other specialist markets.

We have more than 130 members, from Australian and international banks, leading brokers, securities companies and state government treasury corporations to fund managers, energy traders and industry service providers. Our role is to provide a forum for industry leadership and to advance the interests of all these market participants.

AFMA promotes best practice in financial markets so they can continue to contribute to Australia's economic health. We do this by:

- Effectively managing Australia's $78 trillion over-the-counter (OTC) markets;
- Developing widely accepted industry standards for transactional processing;
- Dealing with policy makers on effective regulation of Australia's financial markets to inspire investors' confidence; and
- Encouraging high standards of professional conduct through our professional development and accreditation programs.

Our mission – advancing the interests of members

- Promote Australia as a global centre for financial services;
- Help members grow their businesses and contribute to Australia's economic wellbeing;
- Develop new markets for financial products;
- Encourage existing markets to reach their full potential;
- Lead and sustain effective management of OTC financial markets;
- Represent market participants in exchange-traded markets to ensure effective and efficient market processes and regulation;
- Encourage high standards of professional conduct;
- Develop individual expertise through professional development and accreditation programs; and
- Promote government policies and business conditions that support a strong financial sector.

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2. Comments on Terms of Reference

The Commission's inquiry into barriers to services exports is timely. The contribution of the services sector to the economy and to Australia's exports is often under-appreciated and misunderstood. There are significant opportunities for Australia to increase exports of services, not least financial services to emerging economies in the Asia-Pacific region. The services share of regional economies is expected to grow in line with their economic development and rising per capita incomes.

However, the widespread acknowledgement of the magnitude of this opportunity, exemplified by the 2012 *Australia in the Asian Century White Paper*, and the bipartisan policy aspiration to promote Australia as a regional and international financial centre, has not been matched by the level of policy attention and policy resources devoted to this task. The 2009 Johnson report on *Australia as a Financial Centre* highlighted many of the policy measures that need to be taken to better position Australia to take advantage of the growing regional financial services trade. Yet the report has been remarkable mainly for the slow pace with which its recommendations have been implemented by successive governments. AFMA welcome the opportunity presented by the inquiry to highlight public policy measures that could assist in making the most of these emerging opportunities for the export of financial and other services.

AFMA make the following observations on the terms of reference.

2.1 Barriers to Services Exports

The inquiry's terms of reference are limited to barriers to growth in Australia's services exports. However, it should be noted that barriers to imports of goods and services can be effective barriers to the export of services to the extent that these imports are inputs into the production of services exports. Trade liberalisation in relation to both imports and exports of goods, services, labour and capital are important complements to any attempt to lower policy-related barriers to services exports. Growth in the trade share of GDP (both imports and exports) has been shown to have a large and positive effect on per capita income.[1] This complementarity can be highlighted by the Commission in a way that is consistent with the terms of reference.

A focus on the promotion of exports at the expense of imports can lead to the introduction of policies that distort the allocation of resources in the economy. Economic welfare is maximised by securing the largest volume of imports for a given volume of exports. This is the mechanism through which an improvement in the terms of trade increases national income, by increasing the international purchasing power of domestic production. The focus of public policy should be on the reduction of barriers to trade more generally, of which specific barriers to services exports are a component.

2.2 Existing Free Trade Agreements

The terms of reference are limited to 'barriers to growth in Australian services exports in economies with which Australia does not have free trade/economic partnership agreements.' As noted in the Issues Paper, existing free trade agreements cover 12 of Australia's top 40 trading partners. Free trade agreements are generally considered to be 'living agreements' that leave open scope for

[1] Jeffrey A. Frankel and David H. Romer, "Does Trade Cause Growth?," *American Economic Review* 89, no. 3 (1999): 379–99, doi:10.1257/aer.89.3.379.

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further future reductions in trade barriers. This includes the scope to link existing bilateral agreements into broader regional agreements, such as the Trans-Pacific Partnership, the Regional Comprehensive Economic Partnership and possibly an APEC-wide free trade area. In this context, barriers to exports in all of Australia's major trading partners (MTPs) should be considered relevant to the inquiry. An important element of any trade liberalisation strategy involves the prioritisation of diplomatic and other policy resources to where they can deliver the most economic benefit. The inquiry could assist in prioritising Australia's international trade negotiation strategies by considering trade barriers in all of Australia's major trading partners and not just those where there is no free trade agreement.

It is noted in this regard that the negotiation/renegotiation of free trade agreements needs to be co-ordinated with other bilateral agreements that may impose barriers to the export of financial services. Of particular note is Australia's network of Double Taxation Agreements, which clarify and allocate taxing rights between two jurisdictions and provide certainty for participants within those jurisdictions as to taxation outcomes. AFMA has previously highlighted instances where the take-up of opportunities under a free-trade agreement is undermined by either uncertainty within an existing Double Taxation Agreement or the failure to update the Double Taxation Agreement such that it is contemporaneous with other jurisdictions.

This issue is particularly important in the context of exporting financial services where the undertaking of funds management services in Australia on behalf of an offshore client may, *prime facie*, crystallise a permanent establishment (and hence a taxable presence) for the customer in Australia. There are proposed amendments to the domestic taxation law to ameliorate this risk for non-resident investors, which will enhance Australia's ability to export financial services, but it is imperative that these reforms are supported by Double Taxation Agreements that adhere to best-practice.

2.3 Other Productivity Commission Inquiries

AFMA note that the PC is currently conducting inquiries into the migrant intake (including the greater use of price-based mechanisms for allocating migration rights) and workplace relations. These inquiries should be encouraged to consider barriers to cross-border labour mobility and the implications of labour market flexibility for Australia's international trade competitiveness. Cross-border portability of professional recognition qualifications is one hurdle to the efficient deployment of staff for financial services firms.

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3. Australia's Financial Services Exports

The services sector accounts for over 70 per cent of Australian GDP and is well represented in Australia's exports and investment abroad. The services sector accounts for 17% of total exports on a gross value basis. However, on a value-added basis, the services sector accounts for 41% of total exports, a contribution that exceeds the individual contributions from the mining, agriculture and manufacturing sectors.[2]

The financial services and insurance sectors make a significant contribution to Australia's overall export of services. Much of this trade is not captured by the ABS in its reporting of services exports because these services are supplied by foreign affiliates of Australian firms (Mode 3 in terms of the WTO's General Agreement for Trade in Services (GATS) classification). However, the ABS has periodically surveyed Australia's foreign affiliate trade in services, including by the finance and insurance sector. Australia's stock of foreign direct investment abroad and the flow of income associated with that stock also provides a measure of the extent of Australia's foreign affiliate trade.

Table 1 shows the financial services and insurance sectors contributing around $3 billion to Australia's services exports, over 5% of the total. Growth in financial services exports has outperformed growth in total services exports in recent years. Australia's exports and imports of financial services are shown to be of broadly comparable magnitudes.

[2] AsialinkBusiness, *Australia's Jobs Future: The Rise of Asia and the Services Opportunity*, April 2015, 16.

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Table 1: Financial, Insurance and Pension Services Exports & Cross-Border Direct Investment ($m)	**2011**	**2012**	**2013**
Exports			
Insurance and pension services	411	457	505
Financial services	1289	1627	2468
Total	1700	2084	2973
Share of overall services trade (%)	3.4	4.1	5.4
Total services exports	50049	51200	55070
Imports	2011	2012	2013
Insurance and pension services	866	714	825
Financial services	881	789	1073
Total	1747	1503	1898
Share of overall services trade (%)	2.9	2.4	2.7
Total services imports	59949	63151	69699
Australian FDI Abroad (Finance and Insurance)			
Finance and insurance	99125	112701	140368
Total	405036	445039	494844
Share of total (%)	24.5	25.3	28.4
FDI in Australia (Finance and Insurance)			
Finance and insurance	62400	67590	70312
Total	549390	591341	629941
Share of total (%)	11.4	11.4	11.2

Source: Australian Government, Department of Foreign Affairs and Trade, *Australian Trade in Services, 2013*.

However, the data in Table 1 in relation to exports only cover GATS modes 1 (cross-border supply), 2 (consumption abroad), and 4 (presence of natural persons). Mode 3 sales through a commercial presence abroad are reflected indirectly through the data on Australian FDI abroad.

Irregular ABS surveys of foreign affiliate trade show that around 96% of Australia's financial and insurance services supply to the rest of the world is accounted for by foreign affiliates, totalling $35.1 billion in 2009-10.[3] Table 2 provides a summary of Australia's foreign affiliate trade based on ABS surveys conducted for 2002-03 and 2009-10. It shows that the number of financial and insurance foreign affiliates has increased from 463 to 1245 over this seven year period, growth of 169%. Employment on the part of these affiliates rose from around 51,000 to 76,000, a 48%

[3] Department of Foreign Affairs and Trade, *Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services, 2009-10* (Canberra, 2011), 7.

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increase. Sales of financial, insurance and pension services were $28 billion in 2009-10, an 11% increase on 2002-03. These data highlight the contribution made by foreign affiliates to Australia's services trade and the flow of income to Australian financial services firms from activity abroad.

Table 2: Outward Finance and Insurance Foreign Affiliates Trade in Services	2002-03	2009-10	% change
Number of foreign affiliates	463	1245	168.9
Value of Australian equity in affiliates ($m)		71093	
Employment by foreign affiliates	51047	75919	47.7
Wages and salaries of affiliates ($m)	3028	6668	120.2
Total economic value of sales ($m)	25398	28128	10.7
Total economic value of purchases ($m)	7680	19591	155.1
Profit of affiliates ($m)		6465	
Gross value added ($m)		21168	

Source: Department of Foreign Affairs and Trade, *Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services, 2009-10* (Canberra, 2011)

ITS Global estimates that foreign affiliates of Australian services firms generated revenues of $138 .9 billion in 2013, compared to the $55 billion in direct services exports shown in Table 1. Financial services were the largest contributor, accounting for 40 per cent of total foreign affiliate sales of services.[4]

These data are consistent with the financial services sector playing an important role in the globalisation of Australian business. Foreign affiliate sales by US firms have been shown to be positively correlated with domestic output, employment, direct exports and research and development expenditure.[5] It is expected that foreign affiliate sales by Australian financial services firms would have a similar impact on the Australian domestic economy.

At the same time, the supply of services through an offshore commercial presence may in some cases reflect barriers to the cross-border supply of financial services. It is widely recognised that foreign direct investment is often motivated by 'tariff-jumping' or the need to satisfy local regulatory and governance requirements. In the absence of these barriers, supply might be effected through other modes. Barriers of this type in regional economies may partly account for Asia's low share in Australian services exports and investment compared to relatively open trading partners such as the US and UK. Australia's bilateral regional free trade agreements have addressed many of these barriers at the border, although barriers to trade behind the border may still be significant.

Foreign affiliate activity can also be proxied by the stock of Australian FDI abroad (see Table 1). The finance and insurance sectors accounted for 28.4% of the stock of Australian direct investment

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[4] AsialinkBusiness, *Australia's Jobs Future: The Rise of Asia and the Services Opportunity*, 18.

[5] Gary Clyde Hufbauer, Theodore Moran, and Lindsay Oldenski, *Outward Foreign Direct Investment and US Exports, Jobs, and R&D: Implications for US Policy*, Policy Analyses in International Economics 101 (Washington, DC: Peterson Institute for International Economics, August 2013).

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abroad in 2013 or around $140 billion. Income earned on this stock was $6,392 million in 2013 or around 30% of the flow of income in relation to the total stock.[6]

The dominance of mode 3 supply in accounting for Australia's trade in financial and insurance services may lead policymakers to under-estimate the contribution of the financial services sector to exports and the Australian economy. This highlights the importance of regular ABS surveys of foreign affiliate trade, including on the part of the financial and insurance sectors, to complement the regular reporting of services exports on a balance of payments and national accounts basis.

The contribution of the financial services sector is also under-represented to the extent that the ABS report trade data on a gross value rather than a value-added basis. The ABS should be encouraged to further develop its reporting of trade statistics on a value-added basis and to give greater emphasis to these measures in its statistical releases.

Recommendations: The Commission should recommend that the ABS produce regular surveys of foreign affiliate trade by industry sector and report trade statistics on a value-added basis to more accurately reflect sectoral contributions to exports and the income derived from overseas investments.

Consideration should also be given to allowing ABS greater access to data acquired by financial sector regulators such as APRA and ASIC. This would enable ABS to enhance the quality and quantity of data in relation to the financial services sector. This would require some legislative change.

4. Domestic Barriers to Services Exports

This section focuses on policy-related barriers to financial services exports that are amenable to change through domestic policy and legislation. Barriers considered include relevant local tax rates, the legal structure for managed funds and the regulation of foreign direct investment.

4.1 Australian Government Taxes and Taxation Arrangements

The international competitiveness of Australia's tax system can influence the location of business, business investment and the cost of supplying financial services domestically and abroad. Australia's tax system is not internationally competitive based on the Tax Foundation's International Tax Competitiveness Index.[7] While Australia ranks relatively highly on this index in terms of its overall tax system, it ranks 22nd out of 34 OECD countries in relation to international tax rules and 24th in terms of corporate taxation. These components of the index are the most relevant to the capacity of Australian business to competitively supply foreign markets and decisions by foreign firms exporting services to locate in Australia.

[6] Australian Government, *Trade in Services* (Department of Foreign Affairs and Trade, 2013), 130–131.

[7] Kyle Pomerleau and Andrew Lundeen, *2014 International Tax Competitiveness Index* (Tax Foundation, 2014).

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Table 3: International Tax Competitiveness Index, 2014

Country	Overall Score	Overall Rank	Corporate Tax Rank	Consumption Taxes Rank	Property Taxes Rank	Individual Taxes Rank	International Tax Rules Rank
Estonia	100.0	1	1	9	1	2	11
New Zealand	87.8	2	22	6	3	1	21
Switzerland	82.2	3	7	1	32	5	9
Sweden	79.8	4	3	12	6	21	7
Australia	**78.2**	**5**	**24**	**8**	**4**	**8**	**22**
Luxembourg	77.1	6	31	4	17	16	2
Netherlands	76.6	7	18	11	21	6	1
Slovak Republic	74.2	8	16	32	2	7	6
Turkey	70.3	9	10	26	8	4	19
Slovenia	69.8	10	4	25	16	11	13
Finland	67.4	11	9	15	9	23	18
Austria	67.2	12	17	22	18	22	4
Norway	66.7	13	20	23	14	13	12
Korea	66.4	14	13	3	24	10	30
Ireland	65.7	15	2	24	7	20	26
Czech Republic	64.4	16	6	28	10	12	24
Denmark	63.7	17	14	14	11	28	20
Hungary	63.6	18	11	33	20	17	3
Mexico	63.2	19	32	21	5	3	32
Germany	62.7	20	25	13	15	32	10

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United Kingdom	62.2	21	21	19	29	18	5
Belgium	59.6	22	28	29	22	9	8
Canada	59.0	23	19	7	23	24	27
Iceland	57.2	24	12	16	28	29	16
Japan	54.5	25	34	2	26	25	25
Poland	53.8	26	8	34	27	15	23
Greece	53.4	27	15	27	25	14	28
Israel	53.1	28	26	10	12	27	31
Chile	51.0	29	5	30	13	19	33
Spain	50.8	30	27	18	30	31	14
Italy	47.1	31	23	20	33	33	15
United States	44.3	32	33	5	31	26	34
Portugal	42.9	33	29	31	19	30	29
France	38.9	34	30	17	34	34	17

Source: Tax Foundation

Australia's relatively low rank in relation to corporate taxation is attributable to its relatively high corporate tax rate (26th highest out of 34). The 30% corporate tax rate is well above the unweighted average of 25% for the Tax Foundation's sample of 34 OECD countries. The low ranking for international tax rules largely reflects the operation of withholding tax.

Another ranking of Australia's international tax competitiveness placed Australia 80th out of 100 countries for the period 2005 to 2009.[8]

While Australia's tax system is currently the subject of review, it is worth noting that lowering the corporate tax rate and changes to withholding tax can be made without major changes to the structure of the overall tax system and without a major cost to revenue (given that company tax is largely a withholding tax in respect of domestic shareholders). These arrangements can be viewed as relatively low hanging fruit in the tax reform process and also in relation to policy-relevant barriers

[8] Sara Keller and Deborah Schanz, *Measuring Tax Attractiveness across Countries*, Diskussionsbeiträge Zur Quantitativen Steuerlehre, No. 143, June 2013, 45.

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to services and other exports. Observations on the impact of the tax system on the international competitiveness of services exports would be consistent with the inquiry's terms of reference and may serve as a useful input into the Tax White Paper process.

4.2 Withholding Tax and Offshore Banking Unit Arrangements

A key recommendation of both the Henry Tax Review and the 2009 report from the Australian Financial Centre Forum into *Australia as a Financial Centre* (**the Johnson Report**) was the phasing down of interest withholding tax for financial institutions. Under current settings, financial institutions are required to withhold up to 10% of interest payments out of Australia and remit to the Australian Taxation Office. Noting that this measure was out of step with other jurisdictions, particularly in the Asian region, and also was inconsistent with Australia as a net importer of capital, both the Henry Tax Review and the Johnson Report recommended that financial institutions not be subject to interest withholding tax.

The effects of interest withholding tax applying to cross-border interest payments out of Australia are twofold. Firstly, it reduces the attractiveness of Australia as a destination for mobile capital. Secondly, to the extent that the non-resident lender requires the Australian borrower to "gross-up" for the amount of the withholding tax, as is normal commercial practice, it increases the cost of funding for Australian businesses. Both effects limit the ability for Australian business to fund from offshore.

While the Government in 2011 announced that it would implement the recommendations of the Henry Tax Review and the Johnson Report and phase-down interest withholding tax for financial institutions, this has not yet occurred and it is unclear as to the current Government's policy position on this issue.

The Offshore Banking Unit (**OBU**) regime is designed to provide tax incentives for highly mobile financial sector activities to be undertaken in Australia. These include financial intermediation between borrowers and lenders and providing financial services to offshore investors investing outside of Australia. The concessions provided with respect to eligible transactions are a 10% corporate tax rate and an interest withholding tax exemption for eligible borrowings.

With respect to the export of financial services, there are a number of aspects of the operation of the regime that require refinement or clarification so as to ensure that it operates optimally and is competitive relative to similar regimes in the region. AFMA has recently consulted with Treasury in relation to improvements to the regime and expects a Bill to be introduced into parliament prior to the end of the financial year that will, amongst other things, enhance the ability of Australian personnel to manage both Australian and offshore assets on behalf of a non-resident investor within an OBU. However, it is expected that refinements to the OBU regime will fall short of allowing all financial services to be conducted from an OBU and hence the regime will fall short of its stated policy objectives. For example, it does not appear that the refinements will properly define 'custodial and settlement service' in a way that allows such services to be meaningfully provided by an OBU, and given the pivotal aspect of such services in offering a full suite of financial services to an offshore investor, the absence of such a refinement jeopardises the utility of the regime.

More broadly, we have advocated an alignment between the services that may be provided by an OBU to an offshore investor to the definition of 'financial service' in Section 766A of the

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Corporations Act. This approach would have the advantage of aligning the OBU eligibility requirements to the requirements that trigger a licensing requirement, which is readily understood from a commercial perspective and drafted in a principles-based manner. While this recommendation has not been taken up to date, we maintain that it would be useful in ensuring that the OBU regime remains current and supports the export of Australian financial services.

Recommendation: The Productivity Commission should highlight the implications of Australia's corporate tax rate and international tax rules for Australia's international competitiveness in relation to the export of financial services. The Commission should call for the implementation of those recommendations of the Johnson report that are still outstanding in relation to international taxation arrangements.

4.3 Barriers to Foreign Investment

Australia maintains a relatively open capital account, particularly in relation to portfolio investment flows. However, it adopts a more restrictive approach to the regulation of foreign direct investment in Australia under the Foreign Acquisitions and Takeovers Act (FATA) and the process for reviewing foreign investment applications subject to advice from the Foreign Investment Review Board (FIRB). Restrictions on FDI in Australia can adversely impact Australian services exports by reducing knowledge transfers from foreign to domestic firms and the associated positive productivity spillovers, as well as preventing firms operating in Australia from participating in global managerial networks and supply chains. Restrictions on foreign ownership also potentially reduce the competitiveness of the market for ownership and control of Australian equity capital. This can result in Australian firms being owned and managed by those less able to maximise the value of these businesses and with a focus on domestic at the expense of world markets.

Australia has a relatively restrictive approach to the regulation of FDI, as evidenced by its position on the OECD's FDI Regulatory Restrictiveness Index. Australia ranks as 6th most restrictive among OECD countries on this index (Figure 1). On the financial services sub-index, Australia ranks as the second most restrictive jurisdiction after New Zealand (Figure 2).

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Figure 1

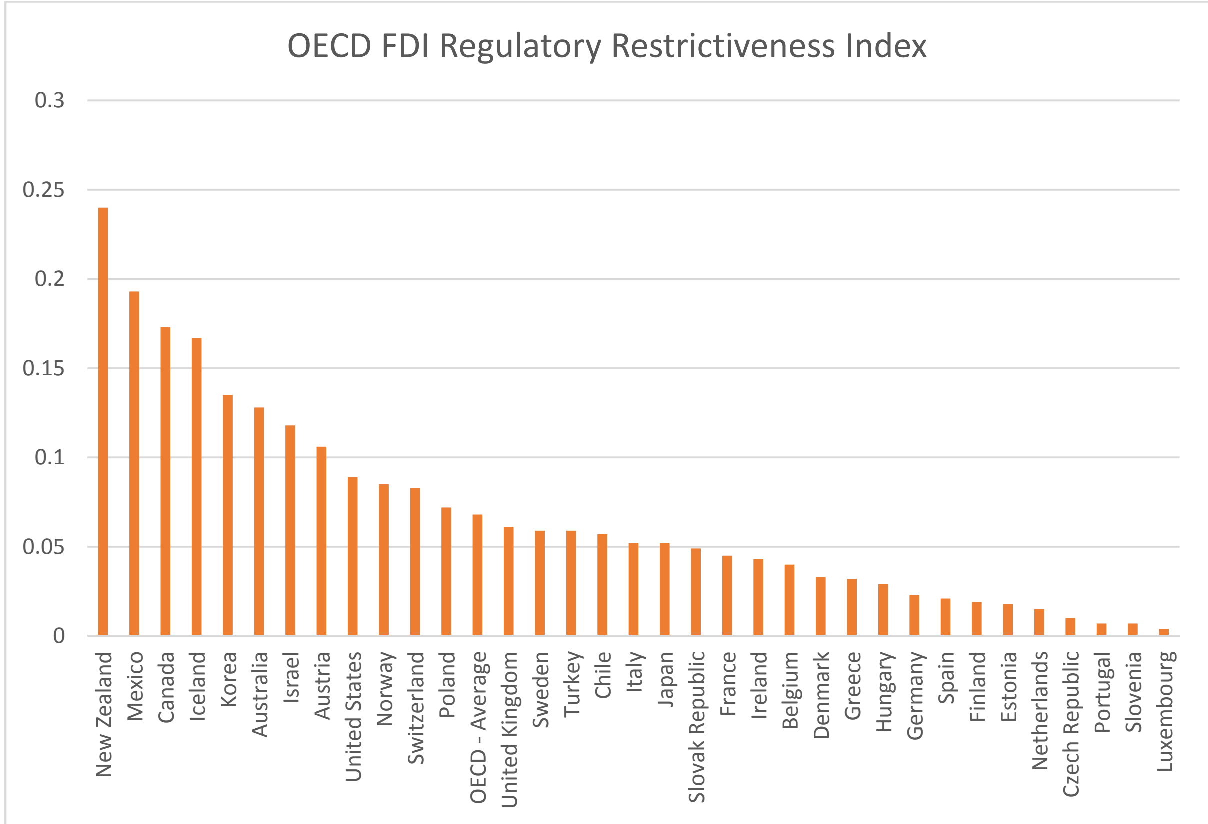
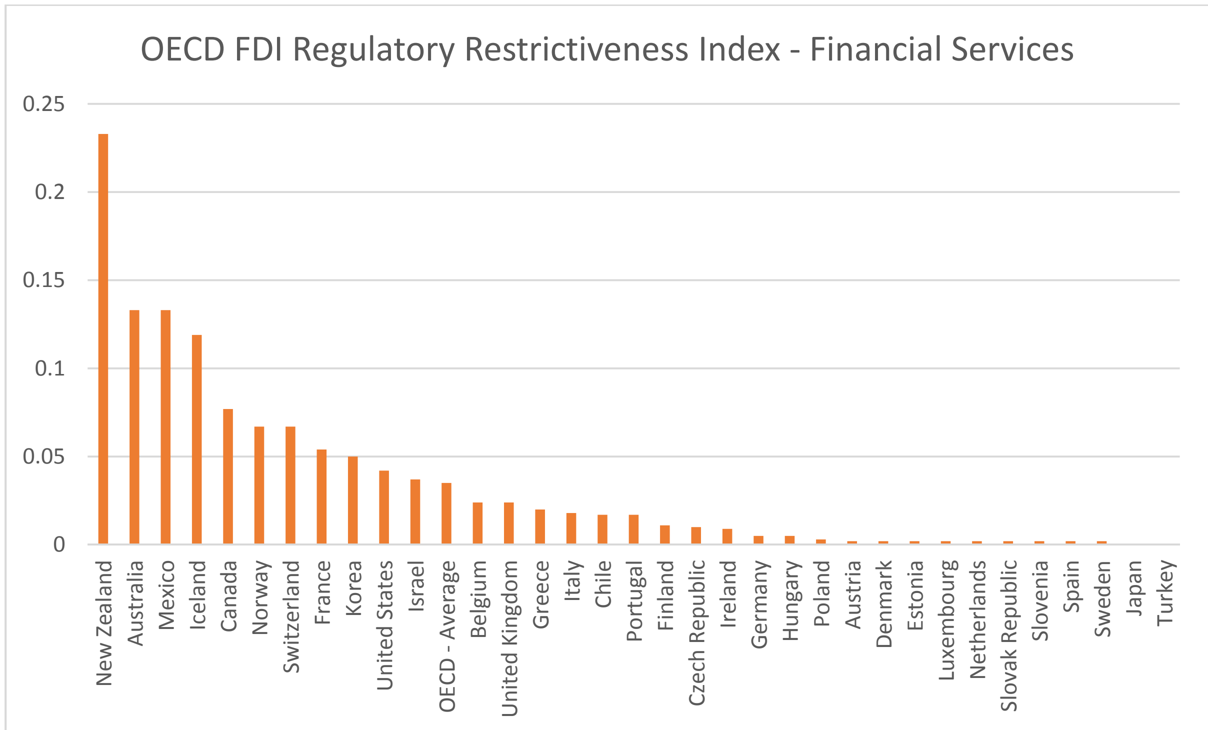


Figure 2



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Australia's relatively poor ranking reflects statutory foreign ownership restrictions and regulatory review processes under the FATA.

Trade consultancy ITS Global estimated the annual direct costs flowing from the administration of Australia's FDI regulatory regime at $5.5 billion in 2008.[9] The cost of delays in the approval process is put at $4 billion, while withdrawn applications cost $1.5 billion.

The FATA and the associated investment application and review process that applies to acquisitions by foreign persons at the border largely duplicates the regulatory framework that exists for business investment behind the border. The FATA adds little that could not be achieved through regulation behind the border on a post-establishment, national treatment basis. For example, the FIRB largely defers to the ACCC when giving advice to the government on issues of competition policy. Foreign firms operating in Australia are subject to the same corporations, securities, competition, industrial relations, environmental and other laws as Australian-owned firms and these laws for the most part operate independently of the FATA. The FATA's open-ended 'national interest' test serves mainly to provide a vehicle for ministerial interference in politically contentious cross-border acquisitions. The low explicit rejection rate for foreign acquisitions under the FATA implies that cross-border investment is subject to unnecessary but costly scrutiny. The implicit rejection rate for foreign investment applications may be higher to the extent that the approval process and the risk of political interference under the FATA deters applications from being made or leads to their withdrawal before consideration by the FIRB is completed.

It is also worth noting that by both deal value and deal number, Australia saw more inbound cross-border mergers and acquisitions fail for political or regulatory reasons between 2008 and 2012 than any other country considered by UNCTAD's 2013 *World Investment Report*, including much larger economies such as the US with a greater volume and value of cross-border acquisitions (Table 4).[10]

[9] ITS Global, *Foreign Direct Investment in Australia - The Increasing Cost of Regulation* (Melbourne: ITS Global, 2008).

[10] United Nations Conference on Trade and Development, *World Investment Report 2013* (New York: UNCTAD, 2013), 99.

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Table 4: Top 10 target and home countries of cross-border M&A withdrawn for regulatory reasons or political opposition, by value and number, 2008–2012

Rank	Target country			Home country		
	Country/economy	Total value ($ billion)	Number of deals	Country/economy	Total value ($ billion)	Number of deals
1	Australia	87.8	8	Australia	112.9	5
2	United States	54.5	7	United States	47.1	7
3	Canada	43.8	4	China	23.6	5ᵃ
4	Hungary	15.8	1	Austria	15.8	1
5	South Africa	11.4	1	India	11.4	1
6	India	8.8	1	Germany	10.2	1
7	United Kingdom	6.7	1	South Africa	8.8	1
8	Taiwan Province of China	5.6	3	Singapore	8.3	1
9	Hong Kong, China	4.1	3	France	6.1	1
10	Switzerland	4.0	2	Hong Kong, China	2.2	1

Source: UNCTAD, based on information from Thomson Reuters database on M&As.
Note: Based on deals with a value of $500 million or more.
ᵃ Combines the seven separate M&A deals related to the withdrawn Chinalco–Rio Tinto deal into one.

Australia also topped the list for outbound M&A transactions withdrawn for regulatory or political reasons, suggesting that Australian investment abroad is also subject to regulatory restrictions in other countries. This may inhibit mode 3 supply by foreign affiliates of Australian firms. It is in Australia's interest to promote a more liberal approach to the regulation of FDI at home so as not to validate the restrictions imposed by other countries that inhibit the further globalisation of Australian business through foreign affiliates and other investments.

A more liberal approach to inward FDI could be expected to enhance Australia's capacity to export through increased knowledge transfers and greater access to global managerial networks and supply chains. Access Economics estimate that a 10 per cent increase in foreign investment could be expected to raise real GDP by 1 per cent to 1.2 per cent over the 10 years to 2020.[11]

The Business Council of Australia has recommended that the $1.1 billion threshold for scrutiny of FDI adopted in recent free trade agreements be applied across the board to private investors from all countries.[12] This would ensure that smaller cross-border acquisitions that are unlikely to raise significant national interest concerns do not receive costly and unnecessary scrutiny. This threshold could also be applied to state-owned enterprises, given that public versus private ownership is not in itself very informative about how business investment should be regulated either at or behind the border.

Recommendations: The Commission should reiterate its previous support for a more liberal approach to the regulation of FDI under the FATA. In particular, the Commission should again recommend that 'Australia apply the same notification threshold to all countries in accordance with

[11] Access Economics, *Foreign Investment in Australia*, Report prepared for the Business Council of Australia, (February 2010), vii.
[12] Business Council of Australia, *Action Plan for Enduring Prosperity* (Canberra, 2013), 112.

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the WTO's Most Favoured Nation principle. This would involve uniform application of the lower threshold currently applying…under bilateral trade agreements.'[13]

The Commission has previously noted that 'There has been no comprehensive review of impediments to flows of foreign capital, inwards or outwards, in recent times despite the continued significance of foreign investment to an economy with Australia's high development potential. It is possible that issues relevant to impediments to foreign investment arise in the course of the current Financial System Inquiry, but given its political significance, it is unlikely that any review will willingly look at the issue holistically without being specifically tasked to do so.'[14] This prediction proved to be correct in relation to the Financial System Inquiry. It did not reference foreign direct investment in its Final Report. With this background in mind, the Commission should recommend that the government give it a reference to conduct a comprehensive inquiry into impediments to cross-border investment and capital flows. Such an inquiry would be a natural complement to the current inquiry into barriers to services exports.

4.4 Flexibility in Structuring Managed Investment Schemes

The introduction of the Managed Investments Act (MIA) 1998 as part of Chapter 5C of the Corporations Act 2001 removed the requirement for an independent trustee. Under this legislation, the dual roles of trustee and asset manager could be unified into a responsible entity (RE). The separate roles of trustee and manager within an RE raised concerns of adequate investor protection as the trustee of a unit trust is appointed to act in the best interests of the investor. However, at the same time, the RE also acts in their self-interest as the investment manager of the unit trust. To address these investor protection concerns, ASIC introduced measures whereby a managed investment scheme is required to have a compliance plan and compliance committee. The merging of both trustee and investment manager functions in an RE was intended to provide an efficient legal structure in the Australian funds management industry.

Critics of the Australian unified approach and other jurisdictions which retain a traditional separation between investment manager and trustee and are apprehensive about recognising its validity say it gives rise to a fundamental conflict of interest between what should be two important roles. It is argued that a RE cannot act in the best interests of the investor as the trustee and, at the same time, act in its own best interest as the investment manager.

Mutual recognition problems coming out of the unified RE approach Australia's regulatory regime put Australian fund managers at a commercial disadvantage comapred to jurisdictions such as Hong Kong, Luxembourg and Ireland. The European Union's rules for investment funds regulated at European Union level 'undertakings for the collective investment in transferable securities' (UCITS) have become a de facto international norm for cross-border collective investment funds. A key feature of UCITS funds is that they must use a separate custodian and must be subject to independent oversight from an external party referred to as a 'depository.' The depository has a blended role consistent with the role played by a traditional trustee and by a custodian. The depository concept is not dissimilar to many economies within the Asia-Pacific, whose collective investment laws recognise the need for both an investment manager and an independent guardian

[13] Productivity Commission, *Trade and Assistance Review 2012-13* (Productivity Commission, 2014), 49.
[14] Ibid., 48.

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(normally a trustee) who oversees the collective investment so that it is operated in the best interests of its investors.

The Corporations and Markets Advisory Committee (CAMAC) in its March 2014 report *The Establishment of Managed Investment Schemes* noted that UCITS funds cannot be registered as a managed investment scheme under the Corporations Act, as the UCITS structure does not recognise Australia's single responsible entity regime. Conversely, it is not possible for a registered scheme (that is, a managed investment scheme registered under Chapter 5C of the Corporations Act) to be a UCITS fund, again, because of the single responsible entity regime. Structurally, Australia fund managers cannot utilise a UCITS compliant platform.

While AFMA considers that our managed investment scheme regime is robust and provides Australian resident investors with an appropriate level of protection, it is an unfamiliar and surprising feature of our system to international investors. It requires a close understanding of our regulatory framework which is an unrealistic expectation when exporting financial services.

Recommendations: The Corporations Act should be amended to provide the flexibility to permit managed funds to adopt a separation of investment manager from trustee to provide structures more familiar to foreign investors. This means allowing a structure which would have been the norm before the 1998 amendment to the Corporations Act.

5. Barriers in Key Trading Partners

5.1 Incidence of Foreign Protectionism Affecting Australia's Commercial Interests

The Global Trade Alert database compiled by the Centre for Economic Policy Research seeks to monitor compliance with the G20's standstill on protectionism announced at its November 2008 summit.[15] The database records 662 foreign state measures affecting Australia's commercial interests, with 68.1% of these measures harming Australia's commercial interests in respect of 77 trading partners. While these measures are not necessarily specific to the services trade, there are indirect effects on services exports given the often complementary nature of trade in goods, services, labour and capital.

Over the same period, Australia announced or implemented 120 measures of which 65% where deemed to harm foreign interests in respect of 79 trading partners. These measures are also likely to harm the interests of Australian producers and consumers that do not directly benefit from these measures.

It should be noted that these data imply significant under-reporting of protectionist measures on the part of the WTO in its role as monitor of the G20 standstill on protection.

Recommendations: The Productivity Commission's annual Trade and Assistance Reviews play a valuable role in highlighting the economy-wide costs of domestic trade and industry policies that discriminate against foreign commercial interests at a cost to Australian consumers and producers

[15] Global Trade Alert, *The Global Trade Disorder: The 16th GTA Report* (London: Centre for Economic Policy Research, 2014).

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and may provoke or help justify similar measures on the part of key trading partners. The Commission should work to ensure that these regular reviews have a high public and media profile.

5.2 Regulation by Foreign Governments and International Standard Setting Bodies

Regulations at and behind the border on the part of foreign governments pose barriers to financial services exports. Of particular significance to financial markets is the scope for inconsistent regulation of financial services supplied on a cross-border basis, even where the intent of the regulation in domestic and foreign jurisdictions is broadly aligned. This highlights the need for greater regulatory harmonisation and mutual recognition of standards applied by foreign governments. International standard settings bodies such as the Basle Committee on Banking Supervision and the Financial Stability Board have an important role to play in this regard.

Australia is something of a 'price-taker' in relation to these international regulatory initiatives. However, it is important that Australia use its influence in international regulatory fora to ensure that Australian financial service providers are not put at a competitive disadvantage by these initiatives. Mutual recognition of regulatory standards is an effective way for governments to apply international regulatory frameworks in a way that minimises extra-territorial impacts and potential impediments to the cross-border supply of financial services.

The lack of a common international reporting standard for capital adequacy on the part of banks can lead to cross-country differences in the application of bank capital rules that reflect different definitions or treatments of bank capital. This in turn can have implications for the international competitiveness of Australian financial institutions. Future changes to prudential standards in Australia should be based on a common international reporting template that harmonises local and international standards.

Attempts by the US and European governments to front-run OTC derivatives reforms mandated by the G20 have been problematic given that many OTC derivatives trades are cross-border in nature. Regulation in one country has had extra-territorial impacts that have lead to the fragmentation of OTC derivatives markets, damaging market liquidity and price discovery.[16] Australia regulators have an important role to play in ensuring that Australian financial services firms and foreign institutions operating in Australia are not disadvantaged in international rule and standard setting processes.

The EU-11's attempt to introduce a financial transactions tax (FTT) would have an extra-territorial impact given the cross-border nature of the transactions it seeks to tax. The EU-11's proposal conflicts with customary international law and may breach EU treaty requirements in relation to its enhanced cooperation procedures.[17] Given the widely-acknowledged welfare-reducing characteristics of transaction taxes, it would be appropriate for the Productivity Commission to highlight the potential harm an EU FTT and similar taxes either domestically or abroad could impose on the cross-border supply of financial services. The Commission should also note that FTTs are inefficient revenue raisers and therefore not a useful addition to the Australian tax system given recent attempts to put an FTT on the domestic tax reform agenda.

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[16] International Swaps and Derivatives Association, *Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis*, January 21, 2014.
[17] PwC, *Financial Transactions Tax: Impacts and Arguments, a Literature Review*, November 21, 2013, 2.

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The US Foreign Accounts Tax Compliance Act is an example of national regulation that had significant extra-territorial impact, increasing the cost incurred by financial institutions globally in servicing US taxpayers. In some cases, non-US financial institutions refused to service US customers to avoid this compliance burden. Such international regulatory over-reach can be particularly harmful to the cross-border supply of financial services.

Recommendations: The Commission should recommend that the Australian government pay careful attention to the implications of international regulatory initiatives in the areas of prudential and liquidity standards and OTC derivatives reforms to ensure that Australian financial institutions are not placed at a competitive disadvantage internationally. The Australian government should use international regulatory fora to promote the mutual recognition of regulatory standards where there is a similar regulatory intent, recognising that regulation needs to be adapted to local conditions. This approach can mitigate some of the impediments to the cross-border supply of financial services that might otherwise arise through poorly coordinated or implemented global regulatory standards.

The Commission should note the potential damage domestic and foreign financial transactions taxes (FTTs) can inflict on cross-border trade in financial services and that these taxes are inefficient revenue raisers.

5.3 Foreign Managed Exchange Rate Regimes, Capital Controls and Financial Repression

Some of Australia's trading partners maintain managed foreign exchange rate regimes. These regimes usually necessitate capital controls that inhibit cross-border capital flows, which in turn limit the scope for cross-border financial intermediation.[18] Foreign capital controls are also often associated with various forms of domestic financial repression, including interest rate controls, credit rationing and directed lending to government and state-owned enterprises.

The motives behind controls over exchange rates and domestic financial markets are complex. While it often asserted that such controls are intended to keep exchange rates under-valued and competitively advantage exports, a more general problem is the misalignment of exchange rates, interest rates and other financial prices with underlying fundamentals. This in turn can be expected to distort the allocation of resources, including cross-border trade in goods, services and capital. The further liberalisation of foreign exchange markets and cross-border capital flows on the part of some of Australia's major regional trading partners such as China can be expected to increase regional trade in financial services. Australian financial services firms are well placed to capitalise on this growth potential given appropriate domestic policy settings.

Recommendations: The Australian government should use its influence internationally to promote flexible exchange rate regimes and open capital accounts. The internationalisation of the Chinese RMB can be facilitated by the Australian government through the promotion of regional trading hubs and bilateral and multilateral currency swap facilities. This in turn can be expected to promote growth in international financial services trade, in much the same way that the floating of the

[18] The global incidence of capital controls is documented in Andrés Fernández et al., *Capital Control Measures: A New Dataset* (Washington, DC: International Monetary Fund, April 22, 2015).

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Australian dollar and financial deregulation in the 1980s promoted the development of Australia's financial markets and services exports.

5.4 Mechanisms for Addressing Barriers to Services Exports

The Issues Paper highlights four mechanisms for addressing barriers to services exports: (1) trade agreements; (2) integration through inter-governmental forums such as ASEAN and APEC; (3) direction negotiation between regulators; (4) direct negotiation between professional bodies.

All four mechanisms can be used to promote financial services exports, subject to the following observations.

(1) *Trade agreements:* Australia has had considerable success in securing bilateral free trade agreements that have facilitated cross-border trade in services and investment. The Australian government should continue to pursue such agreements where there are good prospects for a successful conclusion. The Australian government should also support initiatives such as the TPP and RCEP with a view to building a combined free trade area with the APEC economies.

These efforts should be prioritised over efforts to secure multilateral agreement through the WTO, where progress has been limited over the last decade and where the negotiating agenda now largely excludes services trade and investment. However, it is worth noting that Australia is an active participant in negotiating the Trade in Services Agreement (TiSA) with a sub-set of WTO members. This initiative is worth pursuing.

(2) *Intergovernmental forums:* APEC's Regional Funds Passport initiative provides a framework for the cross-border marketing of managed funds and provides a practical template for cooperation in the Asian region. This initiative should continue to be supported given the significant potential for Australia to export fund management services to the Asia-Pacific region.

(3) *Direct negotiation between regulators*: This submission has already highlighted the importance of mutual recognition of equivalent standards on the part of national regulators. ASIC, APRA and the RBA should continue to engage with overseas counterparts with a view to facilitating Australia's integration with regional financial services trade.

(4) *Direct negotiation between professional bodies*: AFMA is a trade association more than a professional body. It is involved in international standard setting in conjunction with counterpart organisations overseas and international bodies such as the International Swaps and Derivatives Association. AFMA is a member of the International Council of Securities Associations, which assisted in the formation of a global financial consultation group, the Cross-Border Regulation Forum (CBRF), in response to the IOSCO decision to set up a Task Force on Cross-Border Regulation to develop proposals to alleviate barriers to capital flows from regulatory inconsistencies. The CBRF produced a report *Key Issues and Challenges Relevant to the Regulation of Cross-Border Business in Financial Services* which is worthy of note by the Commission.[19]

AFMA supports the development of documentation and operating procedures for OTC markets in which transactions are often multi-jurisdictional. It is important that regulators consult closely with industry and professional bodies to ensure that proposed new regulatory measures in relation to

[19] http://www.afma.com.au/policy/submissions/R20-14_Treasurer_re_G20_Objectives_CBRF.pdf

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OTC markets work as intended, are developed in a coordinated and consistent way and that sufficient time is given for their implementation.

While all four mechanisms can be used as suggested, AFMA note that a more fundamental problem is that the bipartisan policy aspiration to promote Australia as a regional and international financial centre has not been matched by the level of policy attention and policy resources devoted to this task. This is all the more remarkable given the widespread acknowledgement of the magnitude of the opportunity presented by the rise of Asia reflected in the *Australia in the Asian Century White Paper* and related discussion. Greater policy attention has been given to under-performing sectors of the Australian economy. While the politics driving this allocation of political focus are well understood, this is a short-sighted approach to public policy development and implementation.

AFMA noted in its submissions to the Financial System Inquiry that the government does not appear to have a comprehensive strategy for guiding the future development of the financial system, its role in the Australian economy and its integration with the rapidly growing trade in financial services in the Asia region.

There is a lack of policy coordination and role of Treasury in this regard has been impaired by a lack of resources. The lack of follow through in relation to the recommendations of the 2009 Johnson report on *Australia as a Financial Centre: Building on our Strengths* exemplifies these problems.

Recommendations: The Commission should recommend that the government prioritise the promotion of Australia as a regional financial centre and its integration with regional financial markets. A joint government-industry taskforce along the lines suggested by the Johnson report should be mandated to identify impediments to financial services exports in Australia and abroad and obtain political support for their removal or mitigation.

5.5 Export Assistance and Subsidy Schemes

The Australian government maintains several export assistance and subsidy schemes. The Export Market Development Grants Scheme is currently the subject of a review by Austrade due to report by 30 June 2015.

It is important that export assistance and subsidy schemes be evaluated in terms of economy-wide costs and benefits and not just the benefits to particular firms or industries. These measures should only be used to address market failures in financial intermediation or other markets that have been established empirically rather than simply hypothesised. Export assistance and subsidy schemes can distort the allocation of resources in the domestic economy. The excess burden of taxation needed to fund these schemes falls on the rest of the economy and this dead-weight loss is potentially a significant offset to any benefit derived in terms of increased exports.

In this context, it is worth noting that the US Congress is currently giving consideration to allowing the charter of the government-funded Export-Import Bank of the United States to expire.

Recommendations: The Commission should evaluate export assistance and subsidy programs as part of its annual Trade and Assistance Reviews. Where economy-wide costs are found to exceed benefits, the Commission should recommend to government that these programs be wound-up.

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