A REPORT BY ANZ IN CONJUNCTION WITH EY, INDEPENDENT ECONOMICS, ITS GLOBAL AND THE SEXTON MARKETING GROUP

ANZ insight

WINNING THE AWAY GAME: Australia-based Global Companies and the Economy

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ANZ

FOREWORD

ANZ insight is a series of reports that explore the big issues arising from the growth of Asia and the interconnected nature of Australian business with the region.

The issues are increasingly significant to Australia's future prosperity. ANZ expects Asia's share of global economic activity to rise to 35 per cent in 2030 and represent over half the world economy by 2050.

Against this background, ANZ's aim is to share new insights and to encourage a conversation among businesses and stakeholders about the issues and opportunities for Australia, New Zealand and the Asia Pacific region presented by that growth.

Winning the Away Game focuses on the contribution of businesses headquartered in Australia that also have facilities and other assets on the ground in overseas ('away') markets. Traditional exports from Australia and services provided in Australia – the home game – are important foundations for our prosperity. But, to realise the opportunity from Asia's growth, Australian companies have to play and win the away game as well.

The report describes how Australia-based global companies can diversify and grow our economy. It includes brief case studies of four of the many Australian businesses that successfully operate outside Australia. It summarises international research that shows global companies generate a disproportionately high economic benefit for the home economy. Global companies are associated with domestic growth in highly paid jobs, and higher research and development, investment, and productivity. Changes in global patterns of trade mean that offshore investment and presence are assuming greater importance.

Despite the success of many Australian businesses offshore, Australia punches below its weight in outward foreign investment. Australian outward direct investment has been below the Organisation for Economic Co-operation and Development (OECD) average for around a decade and has been on a downward trend.

The report concludes that there is an opportunity to increase Australian investment in offshore businesses and to strengthen our away game through tax reform.

Unlike investors in all OECD countries (except New Zealand), Australian investors face a 30 per cent higher rate of taxation on dividends sourced from foreign profits than on dividends from domestic profits. The resulting tax rate is much higher than in comparable jurisdictions. Consequently, dividends from foreign assets are more valuable to offshore investors than to Australian investors, creating an incentive for Australian offshore assets and businesses to be sold to offshore investors.

Modelling undertaken for this report shows that the reform recommended by the 2003 Board of Taxation *International Taxation* report would generate significant economic benefits. The recommended non-refundable foreign tax credit of 20 per cent would be expected to generate a net economic benefit of more than AUD1 billion per year over and above costs to revenue of around AUD1.75 billion. An additional AUD300 billion of offshore assets would be owned by Australian shareholders.

Benefits arise from higher or less variable returns to Australian investors associated with greater Australian ownership of foreign assets. The benefit of this reform to Australia, relative to its revenue cost, is comparable to the most economically efficient tax reforms.

Current commentary on global companies focuses largely on the use of tax havens and aggressive tax planning by some multinationals. We support international and domestic efforts to address these issues and build public confidence in the fairness of the tax system. Even with necessary taxation reforms though, we will still need to compete to be a base for global companies.

As Australia's and New Zealand's international bank, ANZ clearly has an interest in offshore growth and investor support. It's important to our business and it's important to an increasing number of the bank's domestic clients who are seeking to grow in Asia. Beyond our interest, we see that reform will help realise the opportunity presented by Asian growth, contribute to Australia's success and support the growth of the communities in which we operate.

While the report focuses on Australia, the principles it describes also apply to New Zealand that shares a similar tax structure and challenges. Playing and winning more away games will help both nations diversify and grow our economies, and create more high-value jobs for the future.

Mike Smith

Michael Smith
Chief Executive Officer, ANZ
August 2015

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1.0 EXECUTIVE SUMMARY

1.1 GLOBAL COMPANIES AND GROWTH

Winning in global markets requires Australian businesses to invest abroad. Around 98 per cent of the global economy is beyond Australia's shores with the fastest-growing regions in the world on our doorstep. Asia's share of global economic activity is expected to rise to 35 per cent by 2030 and be over 50 per cent by 2050.

Traditional exports of commodities and sales of services from within Australia are important foundations for the economy. However, to realise the Asian opportunity, Australian businesses will need to be on the ground with their business and consumer customers. Developing Australia-based companies with global scale or specialisation is important for sustaining economic competitiveness over the long term.

Global businesses make contributions to their home economies out of proportion to their size. In a large open economy like the United States (US), their global firms contribute 25 per cent of the country's total economic output, even though they make up less than 1 per cent of its firms.

Offshore investment by global companies generates domestic benefits and is not a substitute for domestic investment. Recent research shows that offshore investment is associated with higher domestic investment, employment, exports, and research and development.

In the US, a 10 per cent increase in capital investment overseas by domestic companies has been shown to generate an increase of 2.6 per cent in domestic investment. McKinsey estimates that every dollar that a US international firm invests abroad yields between USD1.12 and USD1.14 in additional economic activity in the US.

As global trade develops, offshore investment is becoming more important. The global stock of outward foreign direct investment (FDI) has grown twelve-fold to USD26.3 trillion since 1990, while merchandise trade grew less than four-fold. Much of this investment reflects the global trend towards increasing disaggregation and complexity of production.

Goods are no longer produced in a single location in Western Europe or the US. Digital products might be assembled in China, drawing on components, IT, engineering and manufacturing services from countries in different stages of development, such as members of Association of Southeast Asian Nations (ASEAN), South Korea, China, Japan, Taiwan and the US. As supply chains become more international, complex and fragmented, businesses are expanding their presence in different locations.

Global service businesses build networks and invest across different countries. They are becoming more important in global trade, underpinned by advanced technology and telecommunications. In 2013, world merchandise exports grew by 2 per cent in value terms while exports of commercial services increased by 6 per cent.

1.2 AUSTRALIA'S OFFSHORE BUSINESS PERFORMANCE

Some of Australia's most successful companies now do the bulk of their business in overseas markets. In Australia, 63 of the top ASX 100 companies operate internationally with foreign operations generating 37 per cent of their revenue. As described in case studies in this report, some of these companies such as Amcor, Cochlear, Computershare and Westfield need, or have chosen, to invest overseas in order to sustain growth, maintain returns and meet local shareholder expectations.

Taken as a whole, the Australian economy is nevertheless punching below its weight in terms of Australian direct investment abroad. Both flows and stocks of outward direct investment – that is Australian foreign direct investment into overseas markets – have been below the OECD average for around a decade and have continued to trend down against that benchmark. Compared with most similarly sized economies in the OECD, such as Belgium or Switzerland, growth in Australia's outward investment has been weak for the past decade.

Australian global companies are investing more in offshore services and mining, and less in manufacturing. Destinations for investment have changed from the US and United Kingdom (UK) to emerging economies and the Asia Pacific region. An Australian Trade Commission (Austrade) survey of 2,000 Australian companies with international affiliates indicates that around 77 per cent of these companies operate in service industries, with around 17 per cent in manufacturing, 5 per cent in mining and less than 1 per cent in agriculture.

1.3 WINNING THE AWAY GAME

There is a high degree of competition between countries to attract financial capital and human talent. The desire of Australia's global companies to remain 'Australian' and to retain ownership of foreign assets cannot be taken for granted.

Taxation is a key factor affecting the location of global businesses. The existing Australian approach to taxing foreign sourced income at the company level is sound. However, at the shareholder level higher taxes are imposed on dividends paid to Australian shareholders from offshore than on dividends from Australian sources.

Australia compares unfavourably with other jurisdictions in this area. Analysis by EY shows that with the exception of New Zealand, there is no difference in the tax rate applied to dividends from domestic and foreign sources in other comparable jurisdictions.

Dividends paid by Australian companies with significant offshore businesses, or the offshore businesses themselves, will likely be more valuable to non-Australian shareholders. This creates incentives for Australians to own fewer shares in Australian companies investing offshore, for moving Australian offshore businesses to a different jurisdiction, or for Australian businesses to sell foreign assets to others who value those assets more highly.

As part of this process, Independent Economics was asked to model the reform to address the bias against shareholdings in foreign assets. It modelled the 2003 Board of Taxation recommendation of a 20 per cent tax credit for dividends from foreign-sourced income (FSI) that largely eliminates the bias against owning foreign assets.

Independent Economics estimated that the net economic benefit of such tax relief would be AUD1.02 billion per year. The gross economic benefit would be in excess of AUD2.77 billion per year with a cost of AUD1.75 billion per year in tax revenue foregone by the public purse. Based on experience in other jurisdictions, this economic benefit would likely be realised in around two years from the reform's introduction.

Independent Economics also found that the reform would generate net benefits comparable to the highest available from other tax reform options. Consumers would be better off by AUD1 billion per year, over and above budget costs of AUD1.7 billion. An additional AUD300 billion of foreign assets would be owned by Australians. Benefits arise through higher or less variable returns to Australian investors from portfolio diversification associated with greater Australian ownership of foreign assets.

The economic benefit of providing tax relief for foreign dividends compares very favourably with other opportunities for taxation reform. It is a highly efficient economic reform and, relative to its revenue cost, comparable to the benefits from reducing company income tax or conveyancing (stamp) duties.

This change would be a structural reform that should contribute to increasing the number and depth of Australian ownership of global companies based in Australia. It would allow a solid base of investment in Asia to take advantage of free trade agreements and Asia's economic growth.

It would contribute to the diversification of the Australian economy, and creation of more high-value jobs and better commercialisation of Australian research and development. It would create incentives for Australian companies and their foreign assets to remain here and make Australia a more competitive business base for the future.

2.0 GLOBAL COMPANIES AND GROWTH

KEY THEMES:

- *Australia is a relatively small economy on the doorstep of the fastest-growing region in the world.*
- *Australian businesses operating and investing offshore are central to realising the opportunity presented by this growth.*
- *Businesses operating in international markets create high-value jobs, have high productivity levels and are critical channels for commercialising research and development.*
- *Offshore investment-based trade is growing faster than traditional export trade and is a foundation for services exports.*
- *Global supply chains are becoming more complex and fragmented making it more important to have local presence.*
- *New free trade agreements are creating more opportunities for Australian businesses to invest and grow offshore.*

2.1 THE OPPORTUNITY IN GLOBAL MARKETS

Around 98 per cent of the global economy is beyond Australia's shores. While exports from Australia and services provided in Australia will continue to be a foundation of the Australian economy, Australian businesses have to operate offshore to succeed. They have to operate close to their customers and build their offshore presence. They need scale or specialised capabilities to compete in global markets.

Australia is on the doorstep of the fastest-growing region in the world. By seizing the opportunity of Asian growth, we can diversify and grow our economy, and improve the living standards and security of all Australians. Asia's share of global economic activity is forecast to rise to 35 per cent in 2030 and be over 50 per cent by 2050. Australia-based global companies are central to realising this opportunity.

New free trade agreements and other trade treaties will create opportunities for Australian businesses. Newly signed trade agreements with South Korea, Japan and China will open markets for Australia. Other agreements currently being negotiated – the Trans Pacific Partnership Agreement (TPP) and the Trade in Services Agreement (TiSA) – mean that opportunities for Australian business to trade and invest offshore will increase.

2.2 GLOBAL COMPANIES BENEFIT THEIR HOME ECONOMIES

Global companies make substantial contributions to their home economies. In a large open economy like the US, global companies contribute 25 per cent of total economic output, but make up less than 1 per cent of all companies[1].

There are clear benefits to domestic economies from companies that are investing internationally. A 10 per cent increase in capital investment overseas generates an increase of 2.6 per cent in US domestic investment according to one estimate[2]. McKinsey estimates that every dollar that a US international firm invests abroad yields between USD1.12 and USD1.14 in additional economic activity for the country[3]. Recent research shows gains in four key areas: investment, employment, exports, and research and development.

Box 2.1 Free trade agreements and investment opportunities

The China-Australia Free Trade Agreement contains important Most Favoured Nation (MFN) commitments supporting Australian investment in China. The commitments cover computer and related services, construction and related engineering services, education, engineering services, integrated engineering services, environmental services, financial services (securities), forestry services, scientific and technical consulting services, and tourism and travel-related services. This is the broadest MFN services coverage given by China and means that Australia will be treated on par with the 'best' treatment given to any Chinese trading partner under any future trade agreements.

The Japan-Australia Economic Partnership Agreement is the most ambitious trade deal that Japan has ever concluded. It guarantees Australian services suppliers access to the Japanese market in key areas including financial, education, telecommunications and legal services and a range of other professional services.

The Korea-Australia Free Trade Agreement supports one of the strongest and most complementary economic relationships in the Asia Pacific region. It gives Australian services providers the best treatment Korea has agreed to with any trade partner. It eliminates tariffs on nearly all Australia's current exports with its full implementation. Commitments in the Agreement protect and enhance investment between the two countries.

The Trans-Pacific Partnership Agreement (TPP) aims to establish a free trade area in the Asia Pacific. The Asia Pacific region accounts for around 70 per cent of Australia's trade flows and the TPP covers five of the top 10 destinations for outward Australian investment in 2013–14 (US, Japan, Singapore, Malaysia and New Zealand). Australia supports the expansion of TPP membership over time to other economies in the Asia Pacific region.

The Regional Comprehensive Economic Partnership (RCEP) is an ASEAN-centred proposal for a regional free trade area, which would initially include the 10 ASEAN member states and those countries that have existing free trade agreements with ASEAN – Australia, China, India, Japan, Republic of Korea and New Zealand. The 16 participating RCEP countries account for almost half of the world's population, almost 30 per cent of global GDP and over a quarter of world exports.

The Australia-India Comprehensive Economic Cooperation Agreement now being negotiated includes aims to reduce barriers faced by Australian service suppliers and encourages investment between the two nations. India is the world's largest democracy and is a market of 1.2 billion people.

The Indonesia-Australia Comprehensive Economic Partnership Agreement aims to strengthen and expand the trade, investment and economic cooperation relationship between the two countries. Austrade estimates that there are more than 400 Australian companies operating in Indonesia, in sectors including mining, agriculture, construction, infrastructure, finance, healthcare, food and beverage and transport.

Australia is jointly leading, with the US and the European Union (EU), negotiations on a services-only free trade agreement known as the Trade in Services Agreement (TiSA). TiSA parties collectively account for around 70 per cent of global trade in services.

1 Hufbauer et al., 'Outward foreign direct investment and US exports, jobs, and R&D: Implications for US policy', Policy Analyses in International Economics, August 2013.

2 MA Desai, C Fritz Foley & JR Hines Jr, 'Domestic effects of the foreign activities of US multinationals', American Economic Journal: Economic Policy, 2009, 1(1), pp. 181–20.

3 MGI (McKinsey Global Institute), Offshoring: Is it a win-win game?, McKinsey & Company, San Francisco, CA, USA, August 2003.

Global companies contribute significantly to domestic employment. In the US, global companies generate around 20 per cent of all employment (see box).

Investment overseas results in higher salaries at home. A 10 per cent increase in employee compensation abroad gave rise to a 3.7 per cent increase in the compensation paid to US employees[4].

Parent operations in global companies have higher productivity. The share of parent operation turnover is generally higher than the share of employment when compared with affiliates, indicating that parent companies tend to be more capital intensive than labour intensive[5].

Parent company jobs tend to generate smarter jobs. 'Low-wage' jobs in overseas operations do not substitute for jobs in the parent company. The headquarters of companies that invest internationally have more capital-intensive operations than their affiliates. They invest more heavily in research and development (which generate higher-skilled jobs). While various labour-intensive components or parts of a process might be undertaken elsewhere, the capital-intensive operations – requiring higher levels of skill and expertise – are carried out at the company's parent operations[6].

Investment overseas maintains competitiveness and therefore jobs. OECD research demonstrates that companies investing overseas are able to remain locally and globally competitive in changing market conditions – and therefore maintain or increase levels of employment in home economies[7 8].

Box 2.2 Global companies in the US

The Peterson Institute of International Economics, a leading US economic research group, has undertaken a comprehensive survey of the impacts of outward foreign direct investment (FDI) on the US economy. It shows US businesses with significant international operations return significant benefits to the domestic economy: additional jobs, increased exports, and significant investment in research and development.

The Peterson Institute research found:

- In 2007, US global companies generated about 20 per cent of all US employment but comprised only about 1 per cent of all US firms
- Between 2004 and 2009, US international businesses added 1.9 million jobs in the US and 2.1 million overseas; between 1990 and 2000 the ratio of domestic to international job creation was 2 to 1
- The average wage paid (including benefits) to US employees of US global companies was USD69,208 in 2009. This is more than 7 per cent higher than the average wage paid by all firms in the US
- Labour productivity in US global companies is 16.6 per cent higher than that of large domestic companies and 44.6 per cent higher than that of small companies
- Modelling showed that a 10 per cent increase in employment by overseas affiliates leads to a 3.9 per cent increase in domestic employment

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4 MA Desai, C Fritz Foley & JR Hines Jr, 'Domestic effects of the foreign activities of US multinationals', American Economic Journal: Economic Policy, 2009, 1(1), pp. 181–20.
5 OECD, 'Measuring globalisation: OECD economic globalisation', Indicators 2010, OECD, Paris.
6 Ibid.
7 OECD, OECD Employment Outlook 2007, OECD Publishing, Paris.
8 D Marin, 'A nation of poets and thinkers. Less so with Eastern enlargement?', Austria and Germany, CEPR discussion paper, 2004, no. 4358.

2.3 GLOBAL COMPANIES SUPPORT DOMESTIC EXPORT GROWTH

Companies operating internationally tend to be export oriented. In the US, global companies account for around half of the country's merchandise exports, and around 28 per cent of the country's services exports[9].

Global companies outperform their domestic peers. The value of services exported by US-based global companies grew by around 150 per cent over a 10-year period. These companies outperformed their domestically based peers during periods of growth in services exports and maintained positive export growth when domestically based exporters contracted[10].

Exports by global companies are higher value-add. Operations established abroad are typically lower skilled and lower unit-value operations, leaving higher skill-intensive and higher unit-value operations in parent economies where the economic comparative advantage is greater. For example, intra-sectoral unit values of products made in China and the US maintained their relative value in the period between 1990 and 2006. This is described as 'production-fragmentation through outward FDI'. In other words, global companies derive a greater benefit from higher value-add operations such as design and engineering than lower-value functions such as manufacturing[11].

Global companies use overseas operations to complement their domestic operations. Data analysis from about 70,000 European multinational enterprises (MNEs) has assessed the extent to which these companies use exports and foreign direct investment as substitutes or complements. The analysis found that while a small number of the companies employ substitution strategies (shifting business to lower-cost economies), the majority employ foreign direct investment and exports as complements to their business in the home economy[12].

2.3.1 Global companies drive research and development

Global companies undertake greater investment in research and development. US parents of global companies accounted for 74 per cent of all US private-sector research and development expenditures and 29 per cent of all US private-sector investment[13].

Sales by foreign affiliates of global companies result in increased domestic research and development spending. A 10 per cent increase in sales by foreign affiliates of US companies leads to a 7 per cent increase in research and development spending in the US. This is associated not just with overall US employment but also with highly skilled and highly paid jobs.

Investment overseas is a means of acquiring new technologies. Companies often use foreign direct investment as a means to improve research and development, and knowledge capabilities by acquiring patents and proprietary technology in offshore markets[14].

Global companies provide a better enabling environment for innovation. Empirical work indicates that global companies can produce more innovations simply through intra-company collaboration across borders, using existing basic relationships[15].

9 Hufbauer et al., 2013, op. cit.
10 Ibid.
11 L Edwards & R Lawrence, 'Rising tide: Is growth in emerging economies good for the United States?' Peterson Institute for International Economics, Washington, 2013.
12 H Oberhofer & M Pfaffermayr, 'FDI versus Exports: Multiple host countries and empirical evidence', World Economy, 2012, 35(3), 316–30.
13 Hufbauer et al., 2013, op. cit.
14 J Li, Y Li & D Shapiro, 'Knowledge seeking and outward FDI of emerging market firms: The moderating effect of inward FDI', Global Strategy Journal, 26 April 2012, 4(2).
15 H Berry, 'Global integration and innovation: Multicountry knowledge generation within MNCs', Strategic Management Journal, 2013, 35(6).

Case Study 1. Cochlear

Cochlear is an Australian company and world leader in implantable hearing devices. It is one of the country's major exporters.

Cochlear's home grown success is familiar to most Australians. Yet more than 85 per cent of the company's revenues come from offshore. North America and Europe are the company's two largest markets.

Despite this, most of Cochlear's operations – management, research and development, marketing – are based in Australia. The company employs around 2,700 people worldwide; around 350 are employed in Australia at the company's manufacturing plant and research laboratories in Sydney. In 2014, Cochlear spent almost AUD128 million on research and development globally – approximately 16 per cent of revenue.

Much of Cochlear's success and growth is dependent on its investment in both its overseas operations and increased research and development. Its exports go to developed markets and emerging markets alike.

Acquisitions and further investment in research and development have allowed the company to expand its product range. As a result, Cochlear's international expansion allowed it to remain competitive internationally – and secure Australia-based high-skill jobs and high-value exports.

2.4 OUTWARD FOREIGN DIRECT INVESTMENT IS BECOMING MORE IMPORTANT

The global investment landscape has changed significantly over the past three decades. Barriers to foreign investment have fallen in all major economies since the 1990s[16]. Barriers to trade have similarly fallen – approximately 15 per cent between 1995 and 2008[17]. Information and communication technology has made it easier for companies to coordinate operations between and across jurisdictions.

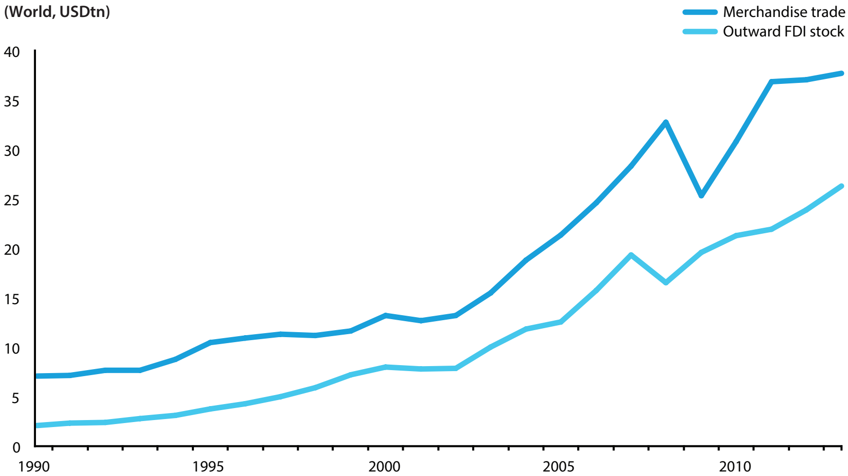
The consequences of this have been twofold.

First, international investment activity has jumped significantly. A key indicator is that foreign investment has expanded faster than trade in this time. The total stock of outward foreign direct investment has grown twelve-fold to USD26.3 trillion since 1990[18], while trade in goods grew less than four-fold[19]. Sales by foreign businesses owned by global companies (foreign affiliates) have grown five-fold over the same period and the assets held by foreign affiliates have ballooned 25-fold[20] (see Exhibit 2.1). In short, internationally focused businesses have expanded their reach over the past 25 years, far faster than domestically focused businesses.

16 OECD, OECD FDI Regulatory Restrictiveness Index, OECD, Paris, 2012.
17 OECD, Global value chains: Challenges, opportunities, and implications for policy, OECD, Paris, 2014.
18 UNCTAD, World investment report: Investing in the SDGs, United Nations, New York & Geneva, 2014.
19 World Trade Organization, International Trade Statistics, WTO, Geneva, 2013.
20 UNCTAD, World investment report, 2014, op. cit.

Exhibit 2.1

GLOBAL OUTWARD FOREIGN DIRECT INVESTMENT STOCK AND MERCHANDISE TRADE, 1990–2013



Source: UNCTAD FDI statistics and World Trade Organization trade statistics.

Second, companies have become more internationalised. A key indicator of this is the 25-fold jump in foreign affiliate assets, referred to above[21]. Merger and acquisition activity almost tripled between 1990 and 2013, with its value increasing five-fold[22].

International investment is essential to remaining competitive. International expansion into new markets, whether through acquisitions or greenfield projects, is not simply a matter of increasing revenue for shareholders domestically or internationally. It is a matter of remaining competitive. As markets globalise, the leading players are those that achieve economies of scale or specialisation. High-speed communications reinforce the advantages of these players.

There is a clear pattern showing that scale or specialisation is required to sustain long-term competitiveness in key markets. With greater access to capital and international expertise, global companies have taken advantage of this changing policy landscape. In the retail sector, for example, the world's top five international retail firms – Walmart, Tesco, Carrefour, Metro and Schwarz – account for around 30 per cent of total foreign sales of the world's 250 largest retailers. All five have undertaken significant investment activity over the past decades, often in the form of acquisitions[23].

2.4.1 Services linked to offshore investment are driving global trade

Global trade in services is becoming the new driver of global trade. Trade in services is growing significantly faster than trade in goods. In 2013, world merchandise exports grew by 2 per cent in value terms while exports of commercial services increased by 6 per cent[24]. Growth in developing economies (where services contribute less to GDP than goods in industrialised economies) has been high; the share of the global services trade of developing countries jumped to 31 per cent from 23 per cent between 2000 and 2013. In 2013[25], growth in China's services exports outpaced its merchandise exports for the first time[26].

21 Ibid.
22 Ibid.
23 Ibid.
24 World Trade Organization, International Trade Statistics, WTO, Geneva, 2014.
25 UNCTAD, World investment report, 2014, op. cit.
26 MOFCOM (Ministry of Commerce of the Government of the People's Republic of China, Service Trade and the 3rd CIFTIS, MOFCOM, Beijing, 2014.

Exhibit 2.2

GROWTH OF COMMERCIAL SERVICES EXPORTS (ANNUAL PERCENTAGE CHANGE) BY CATEGORY AND BY REGION, 1990–2013

	World	North America	South & Central America	Europe	CIS	Africa	Middle East	Asia
Commercial services								
1990–95	8	8	9	-	-	7	...	14
1995–00	5	7	6	4	...	4	...	4
2000–05	11	5	8	13	18	12	13	12
2005–10	9	8	10	7	14	9	10	12
2012	2	5	6	-2	9	7	9	7
2013	6	5	2	7	9	-3	4	5

Source: World Trade Organization statistics.

Many services require offshore investment. The nature of services exports means that some can only be provided through a local presence; therefore, investment in offshore affiliates is required. There are two reasons for this. First, the 'behind the border' nature of services trade restrictions means that knowledge of local legal and regulatory systems is required. Second, it is difficult to deliver significant services exports without investment in an overseas affiliate or subsidiary. For example, in 2012, US services exports through a foreign affiliate were five-times higher than simple cross-border transactions[27].

Services add significantly to the production and export of goods. The services sector contributes more than 50 per cent of the total exports of the US, the UK, France, Germany and Italy. Typically, they contribute one-third of the value of all manufactured products[28]. Similarly, Australia's economy is dominated by services, contributing 73 per cent of GDP, 87 per cent of employment and 39 per cent of value-added exports in 2013.

The importance of the liberalisation of trade in services has only been recently realised[29]. It is now generally recognised that liberalising services will produce a larger growth dividend than has been traditionally assumed. Action to open services markets to international competition is now being undertaken in major trade agreements including the TiSA[30] and the TPP. Most new free trade agreements contain measures promoting services liberalisation[31].

27 UNCTAD, Trade, services and development: The regulatory and institutional dimension, UNCTAD, Geneva, 2014.

28 OECD, Measuring trade in value added, OECD-WTO database on trade in value added, 2013 <http://www.oecd.org/sti/ind/TIVA%20flyer%20FINALpdf>

29 WTO & IDE-JETRO, 'Trade patterns and global value chains in East Asia: From trade in goods to trade in tasks, World Trade Organization & Institute of Developing Economies', Geneva & Tokyo, 2011.

30 Comprising Australia, Canada, Chile, Chinese Taipei, European Union (27 members), Hong Kong, Iceland, Israel, Japan, Liechtenstein, New Zealand, Norway, Republic of Korea, Switzerland, United States, Colombia, Costa Rica, Mexico, Panama, Peru, Turkey, Pakistan, Paraguay.

31 Recent examples include the EU-Singapore Free Trade Agreement, the Korea-US trade agreement and Australia's recent agreements with China, Japan and Korea.

2.4.2 International presence becomes more important as supply chains become more complex

The new global trade and investment landscape means that global supply chains are becoming disaggregated and complex[32]. Global competitiveness hinges on maintaining a presence in these supply chains.

Supply chains or value chains are becoming increasingly disaggregated – the range of components and services suppliers in the supply chain is increasing. Goods once wholly manufactured in South Korea, for example, now might be assembled in South Korea, drawing components, IT or engineering and manufacturing techniques from China, Japan, Taiwan and the US.

Global businesses are able to restructure their supply chains internationally to improve competitiveness. They can take advantage of their international presence, the abundance of human capital or natural resources in multiple locations, and proximity to capital markets.

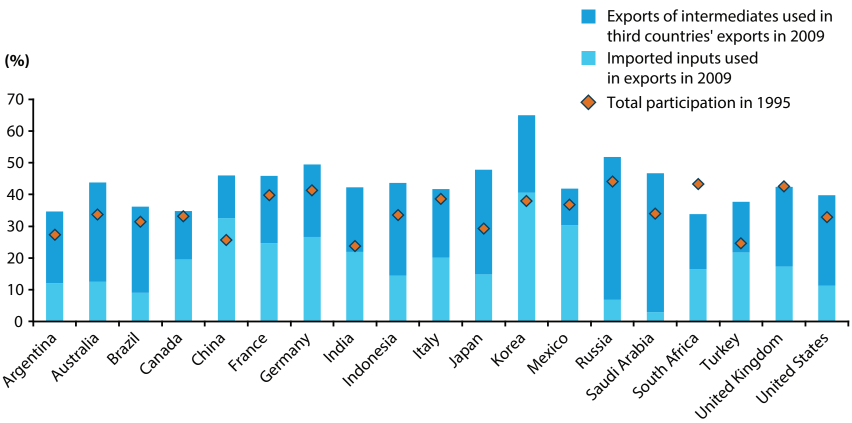
Global businesses have driven these new supply chains. US data indicates that around half of US imports are intra-firm, that is, between the affiliates of US-based multinationals and their US parent[33], and around 30 per cent of US exports are intra-firm. It is estimated that around 16 per cent of global exports are intra-firm.

The pace of disaggregation is increasing. Levels of disaggregation can be measured by trade in intermediate goods, which has expanded in recent decades[34]. Global trade is now equal to around 26 per cent of GDP. This is dominated by trade in intermediate goods and services. Between 1990 and 2011, trade in intermediate goods increased its percentage share of global GDP from 12 to 18 per cent, while the trade in final goods and services has increased from 7 to 9 per cent.

Major economies are participating more in global value chains. For most G20 countries, imported intermediate goods make up between 30 and 60 per cent of exports. For the most part this percentage has increased since 1995, particularly in South Korea, Japan, China and India. This further highlights the significance of the trade and growth opportunities in Asia (see Exhibit 2.3).

Exhibit 2.3

GLOBAL VALUE CHAIN PARTICIPATION ACROSS G20 COUNTRIES, 1995–2009



Note: The index is calculated as a percentage of gross exports and has two components: the import content of exports and the export of intermediate inputs (goods and services) used in third countries' exports.
Source: OECD, 2013.

32 'Disaggregated' means diversity of products and services produced by businesses in different economies, which are finally assembled or embodied into a single product.
33 R Lanz & S Miroudot, 'Intra-firm trade: Patterns, determinants and policy implications', OECD Trade Policy Papers, 2011, 114, OECD Publishing, Paris.
34 World Input Output Database available at <http://www.wiod.org/newsite/home.htm>.

3.0 AUSTRALIA'S OFFSHORE BUSINESS PERFORMANCE

KEY THEMES:

- ***Australian companies that operate successfully outside Australia make major contributions to the Australian economy.***
- ***Although there are many successful Australian global companies, the overall growth of Australia's international investment has fallen away.***
- ***Australia's outward foreign direct investment – that is, foreign direct investment from Australia to other countries – is less than in comparable economies.***
- ***Compared to the OECD ratio of foreign direct investment to GDP, Australia's performance has dropped from around 120 per cent of the OECD average in the 1990s and early 2000s to around 70 per cent in 2013.***
- ***There is strong competition between nations for global companies. Australian companies' desire to remain 'Australian' or retain foreign assets cannot be taken for granted.***

3.1 AUSTRALIA'S OUTWARD FOREIGN DIRECT INVESTMENT PERFORMANCE

Despite the success of many Australian companies overseas, Australia is punching below its weight in terms of its direct investment abroad. Both flows and stocks of outward direct investment have been below the OECD average for around a decade. Growth in Australia's outward direct investment has been weaker than most similarly sized economies for the past decade. In the IMD World Competitiveness Center's most recent annual survey of global competitiveness, Australia's investment performance ranking fell from 17 to 46[35].

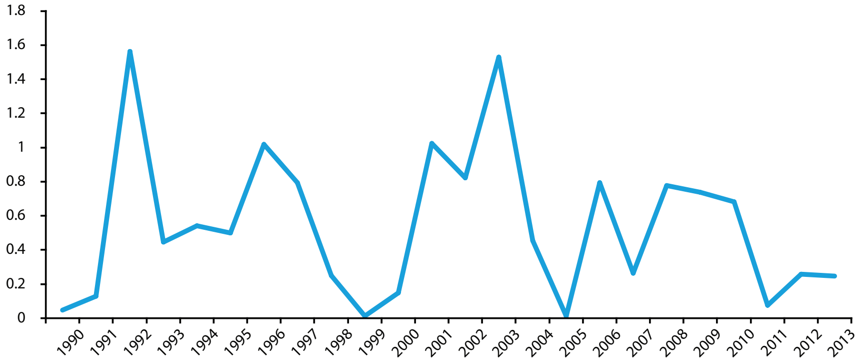
Australian businesses have had a lower rate of direct investment abroad than the OECD average. They have been unable to sustain above-average performance for more than one year at a time.

A comparison of Australian and other OECD countries' outward foreign direct investment is useful to establish Australia's performance. This can be done by calculating the ratio of Australian foreign direct investment flows as a percentage of GDP and assessing this against the OECD average. A ratio of more than one means that Australian businesses are investing abroad at a higher rate than their OECD peers; a ratio of less than one means that they are investing a lower rate. In 19 out of 23 years, Australia's flows of outward foreign direct investment have been below the OECD average (see Exhibit 3.1).

35 IMD, IMD World Competitiveness Yearbook, IMD, Lausanne, 2015.

Exhibit 3.1

FLOW OF OUTWARD FOREIGN DIRECT INVESTMENT AS A PERCENTAGE OF GDP, RATIO OF PERCENTAGE FOR AUSTRALIA TO OECD AVERAGE, 1990–2013



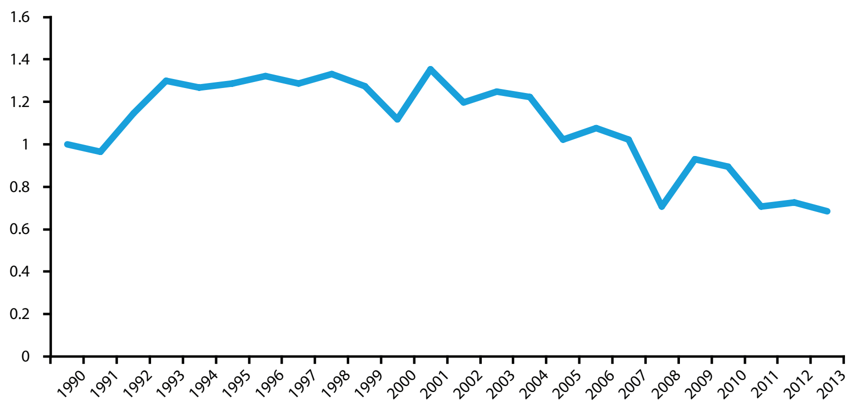
Source: OECD 2014b; ITS Global estimates.

Australia's outward foreign direct investment performance is declining.
The average value of the stock of outward foreign direct investment as a share of GDP held by Australian businesses when compared with their OECD counterparts has been in decline since 1998.

For the OECD as a whole, the stock of outward direct investment as a percentage of GDP has increased, more or less continually, from 9.7 per cent in 1990 to 42.6 per cent in 2013[36]. This is not the case for Australia. The average value of the stock of outward direct investment held by Australian businesses exceeded the OECD average until 1998. This indicator has been in continual decline since then, indicating that the overseas capital stock held by Australian businesses has been growing more slowly than the OECD average (see Exhibit 3.2). The indicator has continued to trend down since the global financial crisis, reaching a new low in 2013.

Exhibit 3.2

STOCK OF OUTWARD FOREIGN DIRECT INVESTMENT AS A PERCENTAGE OF GDP, RATIO OF PERCENTAGE HELD BY AUSTRALIA COMPARED TO THE OECD AVERAGE, 1990–2013



Source: OECD 2014b; ITS Global estimates.

36 Outward FDI stock as a percentage of GDP has the distinct advantage that it tends to filter out much of the natural volatility that is inherent in any time series on investment flows due to lumpiness of investment.

Australia's outward foreign direct investment performance is lower than similar economies. Exhibit 3.3 presents a comparison of the 11 OECD economies most similar to Australia and their stock of direct investment abroad as a percentage of their GDP. Only South Korea (18 per cent of GDP) and New Zealand (10 per cent) had inferior outward investment positions to both the OECD average and Australia in 2013.

Of this group of similar economies, the leading foreign investors were Ireland (231 per cent of GDP), Switzerland (194 per cent), Belgium (186 per cent, latest OECD 2010 data), the Netherlands (134 per cent), Denmark (81 per cent) and Sweden (78 per cent). Their relative outward investment positions are twice to several times the comparable positions of either the average OECD member (43 per cent) or Australia (29 per cent).

Countries in the leading group, such as Ireland and Switzerland, adopt strategies to attract mobile capital and support foreign direct investment. Other countries have responded by adopting similar policies.

Exhibit 3.3

STOCK OF OUTWARD FOREIGN DIRECT INVESTMENT AS A PERCENTAGE OF GDP, BY SELECTED OECD COUNTRIES, 1990–2013

Source of Investment	1990	1995	2000	2005	2010	2013
Australia	9.7	14.1	22.6	26.9	34.6	29.1
Belgium	20.0	28.4	77.3	100.4	185.5	(a)
Canada	14.3	19.6	32.1	33.4	39.4	40.5
Denmark	(a)	(a)	45.7	50.3	71.0	81.3
Finland	8.1	11.5	42.8	41.8	58.2	63.2
Ireland	(a)	(a)	28.7	51.4	162.4	230.8
South Korea	(a)	(a)	(a)	4.6	14.1	17.9
Netherlands	35.6	41.1	79.3	100.9	123.0	134.0
New Zealand	7.4	12.2	11.3	10.2	11.2	10.2
Norway	9.3	15.1	13.6	31.5	44.7	(a)
Sweden	20.4	28.8	49.9	55.8	80.5	78.1
Switzerland	27.1	44.0	90.7	112.3	190.0	193.5
OECD average	9.7	11.0	20.2	26.3	38.8	42.6

Note: (a) percentages are not calculated for negative values.
Source: OECD 2014b.

3.2 THE INTERNATIONALISATION OF AUSTRALIAN BUSINESS

Australian business has been a relative latecomer to outward foreign direct investment. Historically, other similarly developed economies have had a greater propensity to invest offshore. Geographic proximity to larger markets such as Germany, the UK and US was an advantage. In Australia, national policy in the 20th century provided incentives to invest inside rather than outside the country.

Following Federation, the Commonwealth Government progressively adopted policies that discouraged investment abroad. High tariffs encouraged Australian businesses to invest at home and regulation of natural resources dictated business models. There were also geographic limitations, in particular, distance to markets. The 1980s national economic reforms deregulated markets and opened the economy, encouraging inward and outward investment.

Australia's stock of direct investment abroad grew substantially following the 1980s reforms but this performance has lagged over the past 15 years. As at 30 June 2013, the stock of Australian outward direct investment was valued at AUD495 billion[37]. At the equivalent time in 1986, it was worth just AUD31 billion expressed in 2013 prices[38]. Outward foreign direct investment was initially concentrated in the US and UK, but Asia is now a much more significant destination. As part of this trend, outward foreign direct investment also shifted away from manufacturing into mining and services.

Case Study 2. Computershare

Computershare is a global leader in share registry and stock transfer services. Over the years, it has diversified into corporate trust, mortgage servicing, bankruptcy administration and other specialised financial services. Founded in 1978 and headquartered in Melbourne, it operates in over 20 countries and employs more than 15,000 people globally. It listed in 1994 with a market capitalisation of AUD36 million that is now approximately AUD6.8 billion.

The company's original core business was the management of share registries. Computershare created a proprietary software-based solution offering its services to major accounting firms and quickly became a market leader in the share registry industry. Ultimately, Computershare moved vertically and acquired these businesses from the firms it was servicing.

In the mid 90s, Computershare found itself as the domestic market leader but with limited opportunities to expand the core business domestically without running into competition issues. Computershare's obvious choice was to look internationally to expand its business.

Computershare made its first international registry acquisition when it purchased New Zealand-based Registry Managers in 1997. Similar acquisitions took place in the UK, Ireland, South Africa and Hong Kong in the late 90s. North American expansion commenced in 2000 via the purchase of stock transfer services from Harris Bank (US) and the Trust Company Bank of Montreal. Geographic expansion continued into places including Germany, India and Italy.

Computershare typically identifies acquisition targets based on their synergistic potential and its capacity to leverage off its core competencies: ideally, they have a large client base and significant room for efficiency and productivity gains.

Computershare's headquarters in Melbourne is the corporate base for the adaptation of new acquisitions into Computershare's platforms. The bulk of Computershare's global IT staff is located in Melbourne, with key IT functions taking place locally. Australian teams are routinely mobilised to operate abroad when the company makes an international acquisition.

Approximately 85 per cent of Computershare's revenue is now generated outside Australia. This is in part due to the natural limits of the Australian market but also because Australian knowledge, systems and expertise could be effectively brought to bear in international capital markets. A strategy of international expansion has made Computershare the success it is today.

37 Australian Bureau of Statistics Data, 2014.

38 ITS Global estimate based on historical data series on Australia's international investment position (ABS 2001) and the implicit GDP deflator for Australia (IMF 2014). As the ABS changed the way it complies with the measure of Australia's international investment position in 1985, comparable estimates for earlier years are not available.

3.3 AUSTRALIA'S GLOBAL BUSINESSES ARE THE COUNTRY'S HEAVYWEIGHTS

Australia's most successful businesses are among the country's largest overseas investors. Despite this, little is known of Australian investments overseas, either among the public or through official statistics. The Australian Bureau of Statistics does not collate data on foreign-sourced revenue or on Australian companies' offshore businesses.

A survey of 2014 annual reports[39] from the top ASX100 companies shows:

- Sixty-three ASX100 companies operate internationally (ie they have foreign-sourced earnings and/or non-current assets overseas).
- They reported AUD282 billion in foreign-sourced revenue, 37 per cent of total revenue in the geographical segments reported.
- Of those firms with foreign sourced income, on average 49 per cent of total income is sourced from overseas.
- Mining dominates reported foreign income for these Australian companies, and accounts for almost half of foreign-sourced income.

A review of non-current assets reported by ASX100 companies shows:

- They hold more than AUD343 billion in non-current assets overseas, around 24 per cent of all non-current assets held by ASX100 companies.
- The weighted average of the percentage of foreign non-current assets of companies operating overseas is 39 per cent.
- Financial services and mining dominate non-current assets held by listed Australian companies in foreign jurisdictions.

Mining and finance are the leading sectors for Australian companies operating overseas by way of total company numbers.

China and North America are dominant sources of foreign-sourced income. New Zealand is the largest geographical region for non-current assets, followed by North America.

Service industries dominate the operations of Australia's overseas affiliates. An Austrade survey of Australian companies covering 2,000 firms with international affiliates indicates that around 77 per cent of these companies operate in service industries, with around 17 per cent in manufacturing, 5 per cent in mining and less than 1 per cent in agriculture[40].

39 Analysis undertaken by ITS Global. The analysis should be considered an approximation given the lack of consistent definitions for sources of foreign-sourced income (eg sales or dividends) and in geographical segment reporting. Data issued in annual reports for Australian-listed companies generally includes geographical segment reporting for companies with overseas operations. This can include information on the segment's earnings and non-current assets held in that particular segment. However, the company is able to determine the geographical definition of these segments.

40 C Goodman, 'Overseas investment of Australian companies: Trade and investment note', Austrade, Canberra, 2015.

3.4 INVESTMENT BY AUSTRALIAN GLOBAL COMPANIES

3.4.1 Investment destinations

Australia's destinations for investment have changed from the UK and US to emerging economies. The UK and US were Australia's leading direct investment destinations up to 2001 but their importance has since declined sharply. In 1995, they hosted 60.5 per cent of Australia's foreign direct investment: 35.6 per cent in the UK and 24.9 per cent in the US[41].

The UK and US accounted for 34.8 per cent of the total capital stock abroad in 2013, compared to 62.6 per cent in 2001. Investment destinations for Australian businesses have diversified significantly since then. South-East Asia accounted for 5.7 per cent of the total stock of capital directly invested abroad in 2013, compared to 2.8 per cent in 2001. Latin American economies, notably Argentina, Brazil, Chile and Mexico, have been the biggest surprise, with a share of more than 7.8 per cent of the total stock in 2013.

Two changes occurred. First, investment in mineral development offshore accompanied the expansion of exports. This resulted in investment shifts favouring China, ASEAN and selected Latin American economies. Second, foreign investment to expand funds management also increased.

Between 2001 and 2013 Australia's total stock of outward direct investment more than doubled in nominal terms to AUD495 billion. Over the same period, Australia's stock of total investment abroad (in all forms) more than trebled in nominal terms, reaching a total of AUD1.6 trillion in 2013. The fastest-growing components of this investment were portfolio investment, financial derivatives and other investment assets (see Exhibit 3.4) rather than direct investment[42].

Exhibit 3.4

AUSTRALIA'S FOREIGN DIRECT INVESTMENT, PERCENTAGE OF TOTAL CAPITAL STOCK INVESTED ABROAD BY INVESTMENT DESTINATION, 2001 AND 2013

Investment Destination	2001	2013
ASEAN	2.8	5.7
Singapore	0.9	1.8
Rest of ASEAN	1.8	3.9
East Asia	(a)	2.1
China	0.2	1.3
Hong Kong	2.1	0.6
Japan	(a)	0.1
South Korea	(a)	0.1
European Union	20.9	14.8
United Kingdom	15.9	10.2
Rest of European Union	4.9	4.6
North America	(a)	35.9
Canada	1.6	5.8
Mexico	(a)	5.5
United States of America	46.7	24.6
New Zealand	7.1	4.6
Papua New Guinea	0.6	3.6
South America	(a)	2.3

Note: (a) data not published.
Source: ABS 2001 and 2014; ITS Global estimates.

41 The ABS has not published data on Australia's international investment position in the years prior to 1995.
42 'Other investment assets' consist of trade credits, government and central bank loans, IMF credit, deposits with foreign depository institutions (ABS1998).

Case Study 3. Amcor

Amcor is a global leader in packaging. The company tallied USD9.5 billion sales in 2013; it has 27,200 employees across more than 180 sites in 43 countries. Domestic sales constitute less than 5 per cent of Amcor's total.

Up until the late 1980s, Amcor was an entirely domestic paper business. Expansion into packaging in the 1970s was so successful that it had exhausted most of its Australian opportunities within a decade. In the 1980s, the company commenced joint ventures in New Zealand, Singapore and Hong Kong. But it was in 1989, with the acquisition of two North American companies, Sunclipse and Twinpak, that the company significantly expanded its overseas earnings. Two strategic acquisitions in the 1990s (Rentsch and UCB) meant that by 1996, 53 per cent of Amcor's sales were outside of Australia. In the early 2000s, it acquired the PET (Polyethylene terephthalate) plastic business of Schmalbach-Lubeca to become the world's largest PET manufacturer.

Large Australian companies that exhausted domestic opportunities in the 1980s often elected to diversify into other domestic businesses. Amcor moved into international markets, acquired complementary businesses, undertook downstream investments that were less capital intensive, and placed greater emphasis on synergetic acquisitions.

Amcor's acquisitions in 2009–10 of Alcan's packaging assets and the US-based Ball Plastics are a good example. The Alcan acquisition was worth USD2.02 billion. It was projected to increase annual sales by around USD4 billion.

Following these acquisitions there was an increase in margins and returns as well as a step change in the company's operating cash flow and earnings. Profit after tax increased from AUD211.7 million in 2008–09 to AUD600.6 million in 2012–13, a compound growth rate of 29.8 per cent. Profit before significant items and after tax grew by 17.6 per cent to AUD689.5 million in 2012–13. Operating cash flow increased from AUD419.6 million in 2008–09 to AUD739.5 million in 2012–13, a compound growth rate of 15.2 per cent.

There are two points that should be underlined. The first is that 70 per cent of Amcor's earnings are paid in dividends. The second is that 48 per cent of Amcor's shareholder base is in Australia. So, while the overwhelming majority of its operations are outside of Australia, around one-third of the company's earnings – USD230 million – is delivered directly to Australian investors.

Amcor's global structure means the company could be headquartered and domiciled anywhere. But Amcor also points to the efficient nature of regulations around accelerated rights issues in Australia as a major reason for remaining listed in Australia, noting that the company was able to effectively raise USD1.6 billion in 48 hours during the Global Financial Crisis.

But what is significant is Amcor's strategic direction having exhausted opportunities in the Australian market. Amcor recognised that global customers require global packaging solutions that can integrate within connected supply chains, and that it is not simply a matter of importing and exporting containers.

3.4.2 Investment sectors

Australian global companies are investing more in services and mining, and less in manufacturing. Over the past decade, Australia's investment abroad has shifted into mining and quarrying and financial intermediation while investment in manufacturing has declined[43]. Exhibit 3.5 highlights the structural changes between 2002 and 2012 in the industries in which Australian global companies invest.

Exhibit 3.5

AUSTRALIA'S OUTWARD DIRECT INVESTMENT, PERCENTAGE OF CAPITAL STOCK INVESTED ABROAD BY INDUSTRY OF INVESTMENT, 2002 AND 2012

Industry Investment	2002	2012
Agriculture and fishing	(a)	(b)
Mining and quarrying	3.8	39.5
Manufacturing	57.7	15.2
Electricity, gas and water	(b)	(b)
Construction	2.1	3.2
Trade and repairs	2.3	10.0
Hotels and restaurants	(a)	(b)
Transport, storage and communication	4.2	1.8
Financial intermediation	27.2	31.0
Real estate, renting and business services	0.8	(b)
Other services	0.7	(b)
Not allocated to an industry	1.2	3.6

Note: (a) negligible; (b) no data reported.
Source: OECD 2014; ITS Global estimates.

Two structural changes stand out. The first was a surge in capital investment in mining over that decade. This surge was a response to the global commodities boom. The sector's share of Australia's direct investment abroad surged from 3.8 to 39.5 per cent. It also produced a nearly 20-fold increase in the dollar value of the capital stock abroad in the mining sector in nominal terms. This was paralleled by a surge in investment in the domestic mining sector.

The second change was the shift out of manufacturing by Australian companies. The share of manufacturing in outward investment fell from 57.7 to 15.2 per cent. In nominal dollars, capital stock employed in manufacturing effectively halved. This development had domestic parallels in the Australian economy, as local manufacturing investment was crowded out by the domestic boom in mining investment, a high Australian dollar and high manufacturing costs in Australia.

43 As has been noted in the US, statistical declines in manufacturing activity can be misleading as manufacturers outsource input service such as wholesale services. Official statistics classify these services on a standalone basis leading to a potential overstatement of the decline in manufacturing. See AB Bernard & TC Fort, 'Factoryless goods producers in the US', NBER Working Paper no. 19396, issued in August 2013.

Case Study 4. Westfield

Westfield is one of the world's largest shopping centre portfolio managers. The company, founded in 1958, recently demerged into Westfield Corporation and Scentre Group, the former comprising Westfield's international portfolio and business, the latter the Australian and New Zealand portfolio and business.

The Westfield Corporation's international portfolio now comprises interests in 40 shopping centres, with total assets of USD19.6 billion and assets under management of USD28.5 billion. Flagship properties include Westfield London and Stratford City in the UK, and Century City, Garden State Plaza, Old Orchard, San Francisco, Topanga, UTC, Valley Fair and Westfield World Trade Centre in the US.

Westfield's growth story is very much one of international expansion. The company's management understood the opportunities for the business outside Australia and the geographic diversification that could provide. The company's business model in the US was to invest in and upgrade existing shopping malls, which would offset the risk of establishing Greenfield projects elsewhere.

Westfield acquired its first US centre in 1977 and expansion in the US continues today. In 1994, the company acquired 19 shopping centres in the US; it chose to list these US interests on the ASX separately via the Westfield America Trust in order to give Australian investors the opportunity to invest in US properties separately.

The success of its US ventures was followed by expansion in New Zealand, the UK and Europe that continues today. The company's overseas success prompted the merger of its three entities (Westfield and its two related trusts) in 2004. This enabled further expansion and growth through the 2000s.

However, in 2014, Westfield Corporation demerged from its Australian and New Zealand operations (now known as Scentre Group). This was done in order to allow two distinct businesses to pursue different strategies in what are very different markets. Scentre has a strong and mature business while there are significant identified growth and acquisition opportunities internationally.

Westfield Corporation's opportunities are now offshore and it is considering its location for listings. Westfield Corporation employs around 2,000 people globally between its offices in Sydney, UK, US and Europe. Former Australia-based employees that work offshore are in a position to bring their expertise back to Australia.

KEY THEMES:

- ***Competition to attract global businesses is fierce and taxation is a key factor in decision making.***
- ***The existing Australian approach to taxing foreign source income at the company level is sound.***
- ***However, at the shareholder level higher taxes are imposed on dividends from offshore sources than on dividends from Australian sources.***
- ***This creates incentives for Australians to own fewer shares in Australian companies investing offshore, for Australian companies with offshore businesses to move to a different jurisdiction, or for Australian companies to sell their foreign assets to others who value those assets more highly.***
- ***A 20 per cent, non-refundable tax credit for Australian shareholders receiving dividends from offshore sources would largely eliminate the bias against owning foreign assets and the incentives it creates.***
- ***Consumers would be better off by AUD1.0 billion per year, over and above budget costs of AUD1.7 billion. An additional AUD300 billion of foreign assets would be owned by Australians.***

4.1 IS AUSTRALIA A COMPETITIVE BASE FOR GLOBAL COMPANIES?

There is a high degree of competition among countries to attract foreign direct investment, capital and talent. Globalisation and the international nature of business mean that the business environment and taxation are critical factors in where companies headquarter, take up residence or list. It should not be assumed that companies will remain headquartered in Australia or continue to hold foreign assets.

Businesses have become significantly more mobile. The most visible aspect of this has been the relocation of certain production processes (e.g. manufacturing). Companies will move to lower-cost environments because of wage differentials, scale economies, energy prices, local incentives and other factors. Liberalisation in services, reductions in capital control measures in some jurisdictions and increased labour mobility between jurisdictions enable companies to consider a greater range of factors when locating or relocating a business.

Businesses' investment and location decisions are highly sensitive to tax rates. Research by the OECD indicates that a 1 per cent rise in corporate tax results in a foreign direct investment fall of 3.7 per cent. Corporate tax rates affect innovation and productivity growth in the economy[44]. Firms relocate headquarters in response to tax rate changes[45].

New businesses are increasingly aware of taxation treatment. While the consideration of established firms is significant, new market entrants must also be considered, particularly in industries such as software development. In these industries, factors such as location of production centres are less critical, while other factors like the tax treatment of employee share schemes – an essential feature of most tech start-ups – are much more significant.

44 Department of Finance, Ireland, 'Literature review of the economic effects of corporation tax', October 2014, p. 2.
45 J Voget, 'Relocation of headquarters and international taxation', Journal of Public Economics, 2011, 95, pp. 1067–1081.

There is competition among nations to attract investment and capital. The general benefits of attracting foreign direct investment and its potential as a tool for regional economic development are widely recognised by policy makers and analysts. Investment incentives generally take the following forms: tax holidays, special 'tax-free' zones, investment tax credits, investment allowances, accelerated depreciation, reduced tax rates, exemptions from various taxes and financing incentives.

Lower taxes are used to attract foreign direct investment. The Australian Government Tax Discussion Paper, '*Re:think*', highlights how across the OECD and in the Asia Pacific region, countries have reduced corporate tax rates[46]. A 2010 KPMG survey of median corporate tax rates across jurisdictions showed that rates have been declining since 1980 across all economies, whether low, middle or upper-income[47].

Governments also offer businesses incentives to relocate. While there are specific measures to address relocation incentives within countries or jurisdictions (e.g. the EU, Australia and Canada), there are no measures to control relocation incentives internationally.

Australia is performing well in terms of creating an enabling environment for business, but less so on taxation. In the 'World Bank's Ease of Doing Business Index', Australia currently ranks 10th overall. However, in relation to taxation payments and trading across borders, Australia's performance has fallen to 39th in 2015 (from 36th in 2014) for taxation and to 49th in 2015 (from 45th in 2014) for trading across borders.

Measures to improve the integrity of the tax system and stamp out unfair tax practices are important for protecting revenue; they are not intended to reduce competition among nations to attract and retain investment. As the OECD has stated, each country is free to establish its corporate tax system as it chooses, including by charging the rate it chooses. The OECD work is strengthening sovereign taxing rights and unfair erosion of tax bases[48].

4.2 BUSINESS TAXATION IN A SMALL OPEN ECONOMY

An efficient business taxation system for a small open economy like Australia turns on three independent elements. Measures to protect the integrity of, and maintain public confidence in, the tax system are important complements to these.

The three independent elements are:

- Headline rate of company tax – the lower the company tax rate, the higher will be the level of business investment in the domestic economy. This is because pre-tax returns on investment can be lower and more investment can be undertaken
- Tax on income earned by the foreign subsidiaries of domestic companies – foreign subsidiaries are taxed in the foreign jurisdiction and should not face tax in the domestic jurisdiction as well
- Tax on company dividends from domestic and foreign sources in the hands of resident investors – this affects the ownership of shares and diversification of investment portfolios

This paper is focused on the third of these: tax on company dividends.

46 Australian Treasury, 'Re:think, Tax Discussion Paper', Commonwealth of Australia, Canberra, March 2015, p. 74.
47 www.tax.mpg.de/RePEc/mpi/wpaper/Tax-MPG-RPS-2012-06.pdf
48 ANZ supports efforts by international and Australian governments to modernise the international tax framework, reduce international tax avoidance and aggressive tax planning, and put in place sustainable rules to deal with digital and intellectual property-based services. ANZ does not enter into any arrangements that are designed to avoid or reduce the tax that we, our customers or partners, owe. On OECD statements about the purpose of international work on Base Erosion and Profit Shifting, see 'BEPS Frequently asked questions' at www.oecd.org/ctp/beps frequentlyaskedquestions.htm

4.2.1 Tax on company dividends

In a small open economy, the post-tax cost of capital is largely determined in international markets. Capital is available domestically or through international markets (directly or through intermediaries). Rates of return on capital are set by international markets taking into account investment and other risks.

This is because investment returns in the small domestic economy open to international markets will adjust to the returns in the much larger global economy. Sound investments can be funded provided their expected risk-adjusted return exceeds the global post-tax cost of capital. There should be no capital rationing arising directly from a shortage of domestic savings since sound investments may be funded from international markets[49].

Regarding the first element, the company tax rate will determine the pre-tax cost of capital applying to investment in Australia by Australian and foreign investors. This in turn will strongly influence productivity and living standards. The higher the tax rate levied by a jurisdiction, the higher the pre-tax rate of return that its resident companies will have to earn to realise the global post-tax cost of capital.

A high company tax rate means less capital investment is undertaken, and, as a result, productivity and national incomes will be lower. For this reason, countries around the world are lowering company tax rates to boost national incomes.

Regarding the second element, taxing the foreign earnings of resident companies can reduce their offshore activity. Small open economies generally apply their corporate income tax to the domestic earnings of resident companies; foreign earnings are not taxed unless they originate in a recognised tax haven. The rationale for doing so is that resident companies can easily avoid corporate taxation by relocating to an economy that has a source-based regime for its corporate income tax. In this case, the previous host economy would lose all the economic activity associated with these companies.

The existing Australian approach to taxing foreign source income at the company level is sound. While Australian companies are technically taxed on their worldwide income, there is an exemption for Australian-owned subsidiaries and affiliates with offshore businesses. This means that Australia's company taxation regime is generally neutral in its treatment of domestic and foreign income sources.

The foreign subsidiary or affiliate of an Australia-based company will generally pay company tax to its host jurisdiction on any income earned there. Its Australian parent, however, will not be liable for company tax in Australia on the same income, ensuring that there is no double taxation at the company level. This is comparable with most developed countries' tax systems.

Regarding the third element, the Australian tax system is biased against Australian investors owning companies with significant foreign businesses. The bias arises when the Australian-resident company distributes foreign income as a dividend to shareholders. In that case, Australian-resident shareholders receive no relief for the company tax that the company – through its subsidiary or affiliate – has paid in the foreign jurisdiction where they operate. As a consequence, those shareholders will pay personal income tax on such a dividend at their full marginal tax rates.

49 MP Devereux, 'Taxation of outbound direct investment: Economic principles and tax policy considerations', Working Paper, 2008, no. WP 08/24, Oxford University Centre for Business Taxation, Saïd Business School, Oxford, UK.

Box 4.1 The tax bias: opinions from taxation reviews

The most recent reviews of the Australian taxation system, by the Board of Taxation in 2002-03 and in 2009 by a panel led by then Treasury Secretary Ken Henry, have recognised the bias against foreign income but responded in fundamentally different ways[50].

In 2002, the Treasurer asked the Board of Taxation to review Australia's international tax arrangements. The Board recommended that:

– domestic shareholders be given tax relief for unfranked dividends paid out of foreign source income

– a non-refundable tax credit of 20 per cent be provided with no need to trace the foreign tax paid or incurred.

The Board expected that these recommendations would help to transform Australian companies into world-class businesses by:

– removing the bias against investment by Australian residents in Australian companies

– promoting more efficient methods of raising capital for both offshore and domestic investment

– encouraging Australian companies to repatriate profits to Australian shareholders rather than quarantine them overseas.

The 2009 Henry Review stated "the non-creditability of foreign taxes may increase the required return for offshore investment, discouraging such investment and encouraging a domestically focused investment focus".

The Henry Review argued that the resulting tax bias may be beneficial from a national perspective because paying foreign tax does not benefit Australian government revenue. However, it noted that this view assumes that there is no-spill over benefit from foreign direct investment and such investment was a substitute for, rather than a complement to, domestic investment.

It made no recommendation to change the existing treatment of dividends from foreign-sourced income. However, it advocated considering alternatives to company tax arrangements as a whole that may have addressed the issue over time.

50 The Board of Taxation, 'International taxation – a report to the Treasurer, February 2003. Department of the Treasury, 'Australia's future tax system - Report to the Treasurer', December 2009, refer to B2-3 'The future of dividend imputation' at p. 191.

4.3 AUSTRALIA'S INCOME TAX SYSTEM IS BIASED AGAINST FOREIGN INCOME

Dividends paid to Australian shareholders from foreign earnings face a 30 per cent higher tax rate. Exhibit 4.1 compares the rates of income tax that Australia applies to investment income from different sources as calculated by EY for ANZ. To reflect the situation of most Australian investors, EY has calculated results for three investor groups, based on the following marginal tax rates:

- 15 per cent, representing superannuation funds in the accumulation phase and investors on the lowest marginal tax rate
- 34.5 per cent, representing investors on the middle marginal tax rate[51]
- 47 per cent, representing investors on the top marginal tax rate.

Exhibit 4.1

RATE OF INCOME TAX APPLIED TO DIVIDENDS RECEIVED BY AN AUSTRALIAN RESIDENT, BY MARGINAL TAX RATE OF THE INVESTOR, PERCENTAGE OF GROSS EARNINGS ON THE INVESTMENT (A)

Source of Income (AUD)	Marginal tax rate of resident investor		
	Bottom rate (15%)	Medium rate (34.5%)	Top rate (47%)
Franked dividend paid out of domestic earnings	-15% (b)	4.5%	17%
Unfranked dividend paid out of foreign earnings	15%	34.5%	47%
Difference in applied tax rate, unfranked vs franked earnings	30%	30%	30%
Income from a $1,000 profit (c)			
Franked dividend paid out of domestic earnings	$850	$655	$530
Unfranked dividend paid out of foreign earnings	$595	$458	$371
Difference in income, unfranked vs franked earnings	$255	$197	$159

Note: (a) Tax rates are those as at 1 July 2014; (b) Taxpayer receives a tax refund; (c) Assuming franking credits in the domestic earnings scenario and 100% foreign-sourced income in the foreign earnings scenario.
Source: EY estimates.

The EY calculations are based on the tax rates at 1 July 2014[52]. For simplicity, they assume that the investor is a pure portfolio investor who invests in Australian companies with overseas operations conducted by wholly owned subsidiaries or affiliates, and the investor does not receive any credit for the tax paid by the company's subsidiaries.

The EY calculations show that the Australian resident shareholder on the highest marginal tax rate pays income tax equivalent to 17 per cent of the gross value of a franked dividend, compared to 47 per cent on an unfranked dividend. At the other end of the scale, a resident shareholder on the lowest marginal tax rate is eligible for a tax refund equivalent to 15 per cent of the gross value of a franked dividend but has to pay tax equivalent to 15 per cent in the case of an unfranked dividend. For all shareholders, there is an additional 30 per cent Australian tax payable on unfranked dividends.

51 From 1 July 2015 the lowest rate in the personal income tax scale will, in fact, be 18 per cent.
52 The calculations do not take account of the proposed cut in the headline rate of company tax from 30 to 28.5 per cent or the proposed Paid Parental Leave Levy. The Commonwealth Government has foreshadowed them as being introduced from 1 July 2015.

These tax differentials create a disincentive for Australian shareholders investing in Australian resident companies investing overseas.

4.3.1 Other jurisdictions do not have this bias

Australia compares unfavourably with other jurisdictions. EY also assessed the taxation treatment of dividends from domestic and foreign sources in jurisdictions broadly comparable to Australia. The countries selected for this purpose were Canada, China, Germany, Ireland, Japan, Malaysia, the Netherlands, New Zealand, Singapore, South Korea, Sweden, Switzerland, the UK and the US. They represent Australia's major trading partners, its major sources of inward foreign investment, and its major destinations for outward investment.

Exhibit 4.2

DIFFERENCE IN INCOME TAX RATE APPLIED TO FOREIGN AND DOMESTIC DIVIDENDS FOR A RESIDENT INVESTOR, SELECTED COUNTRIES, PERCENTAGE-POINT DIFFERENCE AS AT 1 JULY 2014 (A)

Country	Tax bias against foreign income (%)
Australia	30
Canada	0
China	0
Germany	0
Ireland	0
Japan	0
Korea	0
Malaysia	0
Netherlands	0
New Zealand	28
Singapore	0
Sweden	0
Switzerland	0
United Kingdom	0
United States of America	0

Note: (a) Estimates based on a dividend paid by a resident company to a resident investor on highest rate in personal income tax scale.
Source: EY estimates.

With the exception of New Zealand, there is no difference in the tax rate applied to dividends from domestic and foreign sources in other comparable jurisdictions. EY has estimated the tax rates applied to dividends distributed by a domestic company to resident investors. For simplicity, the estimates are based on the rates applied to investors at the top marginal rate of personal income tax. Exhibit 4.2 summarises the difference between the tax rate applied to dividends paid out of domestic income and the rate applied to foreign income. A positive result indicates the additional rate of tax applied to foreign income, while a nil result indicates that neutral treatment.

In 13 of the 14 countries there is no difference in the tax rate applied to dividends from domestic and foreign sources. Moreover, the bias in Australia against foreign income is more severe than that in New Zealand, the only other country to maintain such a bias.

4.3.2 The ownership of foreign assets of Australian companies will tend to shift to foreigners

Dividends earned from the foreign businesses of Australian companies, or the assets themselves, will likely be more valuable to foreign shareholders than to Australian shareholders. Exhibit 4.3 shows that countries such as Canada, China, South Korea, Malaysia, Singapore, Switzerland, the UK and the US will have relatively lower rates of tax on dividends than that applied to an Australian investor.

Exhibit 4.3

TAXATION OF DIVIDENDS FOR A RESIDENT PERSONAL INVESTOR BY SOURCE, SELECTED COUNTRIES, AS AT 1 JULY 2014 (A)

Country	Domestic dividends	Foreign dividends
Canada	Non-refundable tax credit: 20.73% for eligible dividends; 13% for other dividends	Same as domestic dividends
China	Flat tax rate of 20%	Same as domestic dividends
Germany	Flat tax rate of 25%	Same as domestic dividends
Ireland	No offset to or exemption from personal income tax	Same as domestic dividends
Japan	Flat tax rate of 20% on dividends paid by listed companies	Same as domestic dividends
South Korea	Flat rate of tax of 15.4% on income from minority shareholdings; subject to a threshold	Same as domestic dividends
Malaysia	Full exemption from personal income tax	Same as domestic dividends
Netherlands	Flat tax rate of 30%; or 25% for income from shareholdings ≥ 5%	Same as domestic dividends
New Zealand	Dividend imputation regime with non-refundable tax credit	No concession or exemption
Singapore	Full exemption from personal income tax	Same as domestic dividends
Sweden	Flat tax rate of 30%; or full tax exemption for income from shareholdings ≥ 10% (subject to conditions)	Flat tax rate of 30% but no exemption for shareholdings ≥ 10%
Switzerland	Partial tax exemption w.r.t. income from shareholdings ≥ 10% (only 60% of the dividend is taxable)	Same as domestic dividends
United Kingdom	Non-refundable tax credit of 10% and reduced tax rate (up to 37.5%)	Same as domestic dividends
United States	Reduced tax rate of up to 20%	Same as domestic dividends

Note: (a) Assuming taxpayer is on the highest marginal tax rate; does not include pension or superannuation funds.
Source: EY estimates.

Foreign assets effectively return less to Australian investors than to investors in other foreign jurisdictions. As indicated in the simplified example in Exhibit 4.4, dividend streams from offshore profits are typically worth less to Australian investors that to investors in other jurisdictions. This creates incentives for Australians to own fewer shares in Australian companies investing offshore, for Australian companies with offshore businesses to move to a different jurisdiction, or Australian companies to sell their foreign assets to others who value those assets more highly.

Exhibit 4.4

SIMPLIFIED EXAMPLE OF RELATIVE VALUE OF DIVIDENDS PAID FROM AFTER-TAX PROFITS OF AUD1,000 (A)

All dollars amounts in AUD	Australian	Unites States	United Kingdom	Japan	Singapore
Dividend Received from subsidiary paid in-turn to a domestic shareholder	$1,000	$1,000	$1,000	$1,000	$1,000
Tax paid by domestic high-rate shareholder	$490	$200	$313	$200	$0
After-tax dividend to the ultimate shareholder	$510	$800	$688	$800	$1,000
Relative value to shareholders	100%	157%	135%	157%	196%

Note: (a) Assuming taxpayer is on the highest marginal tax rate.

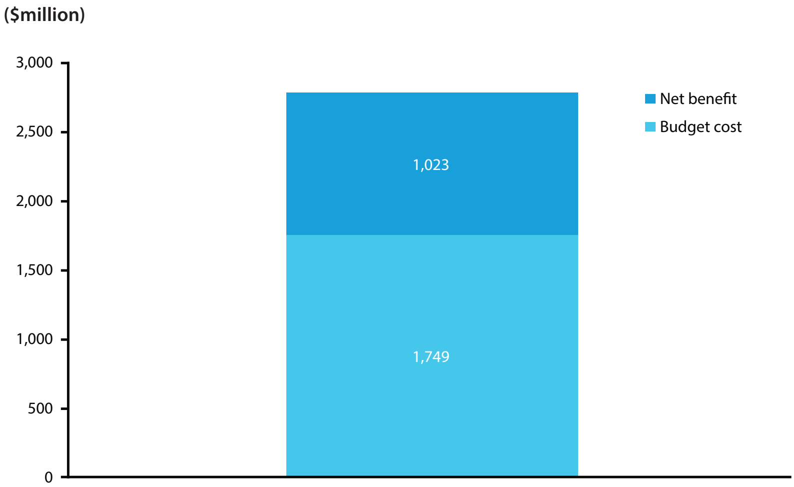
4.4 THE ECONOMIC BENEFIT OF TAX RELIEF FOR FOREIGN DIVIDENDS

A 20 per cent non-refundable tax credit for Australian-resident shareholders receiving dividends from offshore sources would generate a substantial net economic benefit for Australia. This is the case after allowing for costs to government revenue of addressing the bias. ANZ commissioned Independent Economics (IE) to estimate the economic impacts of providing double tax relief on foreign income.

IE estimates that the net economic benefit of such tax relief would be AUD1.02 billion per year. Exhibit 4.5 shows that the gross economic benefit would be in excess of AUD2.77 billion per year[53]. IE has also estimated that the foreign tax credit would cost AUD1.75 billion per year in terms of tax revenue foregone by the public purse, resulting in the net economic benefit of AUD1 billion per year. Based on experience in other jurisdictions, this economic benefit would likely be realised in around two years from introduction of the reform.

Exhibit 4.5

ANNUAL GROSS BENEFIT, BUDGET COST AND NET BENEFIT OF 20% TAX CREDIT



Source: Independent Extended CGE model.

53 Estimated in terms of the average price level for the 2013–14 financial year.

Box 4.2 Modelling by Independent Economics

A change in tax policy to remove the bias against offshore investment by Australian taxpayers is expected to generate economic benefits of AUD1.60 for every dollar of tax revenue that would be foregone. IE assumed that relief would take the form of a non-refundable tax credit of 20 per cent on foreign dividends paid by Australian companies.

Its analysis was based on its Extended Computable General Equilibrium (CGE) model of the Australian economy, specially enhanced for this assignment. The enhancement comprised a customised module to simulate the economic impacts of changes in the taxation of foreign dividends.

The IE model assumes that financial capital is perfectly mobile internationally, consistent with the small open economy view of Australia. Under the model's strict approach, Australian companies are not assumed to expand offshore as a result of the proposed reform. At the company level, there is no double taxation of foreign earnings and the Australian approach is sound. Benefits arise from higher or less variable returns to Australian investors associated with greater Australian ownership of foreign assets.

ANZ believes that in practice, companies would respond to the reforms and that the IE model will underestimate the total benefits of reform.

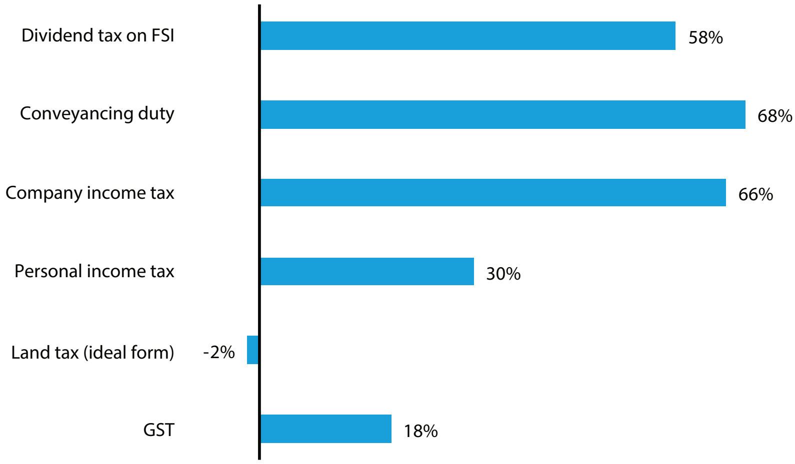
The IE modelling results represent the long-term outcomes of introducing a 20 per cent non-refundable tax credit, in other words after the structure of the economy has fully adjusted to the tax policy change. The results were estimated as deviations from a baseline scenario of no change in any public policy or in the settings that are used for any current policy measure. The policy focus is not limited to tax policy.

Removing the bias is an efficient policy measure. Expressed as a percentage of the revenue foregone, the net economic benefit is 58 per cent of the budgetary cost. In other words, the marginal dollar of taxation, which is currently collected from foreign dividends, costs the Australian community 58 cents in consumption foregone. This is much higher than the equivalent cost of the marginal dollar that is collected by each of the major Commonwealth taxes, such as the personal income tax and the GST.

The economic benefit of providing tax relief for foreign dividends compares very favourably with other opportunities for taxation reform. Exhibit 3.6 shows the relative economic cost of different types of tax (the 'marginal economic burden'). The effect of the current Australian situation, a dividend tax on foreign source income (FSI), is shown as the first row. Economically, inefficient taxes have high marginal excess burdens and efficient taxes have low marginal excess burdens. Reducing dividend tax is then a highly efficient economic reform, compared to the benefits from reducing company income tax or conveyancing (stamp) duties.

Exhibit 4.6

MARGINAL EXCESS BURDENS OF KEY TAXES IN TAX REFORM AGENDA



Source: Independent Extended CGE model.

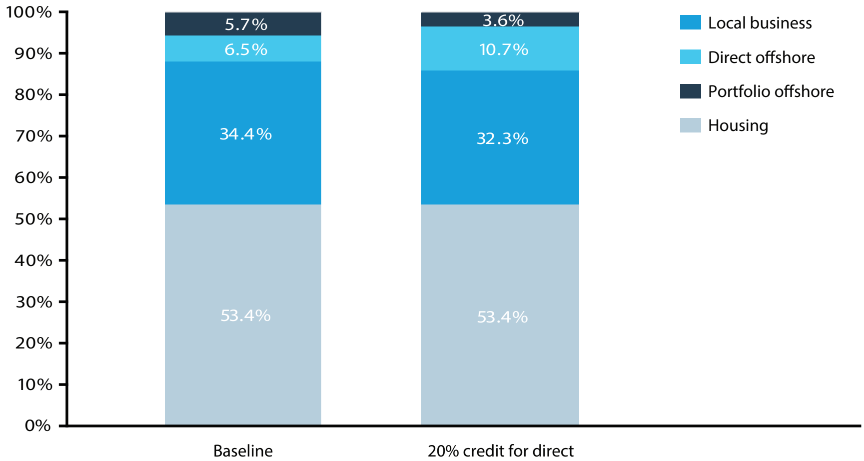
A foreign tax credit would mean that Australian residents would invest more in Australian businesses with offshore businesses. As shown in Exhibit 4.7, investment rises substantially from 6.5 to 10.7 per cent of the total wealth of Australian residents. This is equivalent to around AUD300 billion in absolute terms.

This increase would be accompanied by a reduction in Australian investment in foreign companies and a marginal reduction in investment in domestically focused companies. Reduced investment in Australian companies would have no impact on the national economy and growth since offshore investment into Australia would increase slightly.

The greater diversification of the investment portfolios of Australian residents means that their returns would be less volatile. This would also be the case for the annual consumption of the beneficiaries of that wealth.

Exhibit 4.7

PORTFOLIO SHARES



Source: Independent Extended CGE model

4.5 AUSTRALIA BENEFITS

A non-refundable tax credit of 20 per cent would be expected to generate a net economic benefit of more than AUD1 billion per year over and above costs to revenue of around AUD1.75 billion. It would increase investment in Australia-based companies with offshore businesses by around AUD300 billion. The benefit of this reform, relative to its revenue cost, is comparable to the most attractive tax reforms.

This change would be a structural reform that should contribute to increasing the number and depth of Australia-based global companies. It would allow a solid base of investment in Asia to take advantage of free trade agreements and the growth of Asia.

The reform would contribute to the diversification of the Australian economy, and creation of more high-value jobs and better commercialisation of Australian research and development. It would create incentives for Australian companies and their foreign businesses to remain in the country and make Australia a more competitive business base for the future.

ABOUT THE AUTHOR

ANZ thanks and acknowledges the assistance of EY, Independent Economics, ITS Global and the Sexton Marketing Group in the development of this report.
EY is a globally integrated professional services organisation. Independent Economics is an independent provider of economic modelling services to support economic policy analysis and forecasting. ITS Global is a dynamic consultancy specialising in public policy in the Asia Pacific region. The Sexton Marketing Group provides market research services to private and public sector clients in Australia, New Zealand and selected Asian Countries.

ILLUSTRATOR

The illustrations in this report are the work of artist Noma Bar.

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