SUBMISSION TO THE PRODUCTIVITY COMMISSION
REVIEW INTO BARRIERS TO GROWTH
IN AUSTRALIAN SERVICES EXPORTS

MAY 2015

CONTENTS

SUMMARY

1. Australia's services sector accounts for 75 per cent of Australia's economic growth and makes a critical contribution to exports and foreign income. The ANZ PwC Asialink Services Report *Australia's Jobs Future: The Rise of Asia and Services Opportunity* estimated that services are Australia's largest export on a value added basis. Foreign branches of Australian businesses generated further revenue of $138 billion in 2013, largely concentrated in Australia's traditional markets rather than Asia.

2. ANZ strongly supports the Government's efforts to address barriers to trade in services, particularly across Asia. Strengthening services exports will help Australia realise the opportunity presented by the growth of Asia and its service sectors. *Australia's Jobs Future* estimates that by 2030, Australia's annual services exports to Asia could be worth $163 billion and support a million Australian jobs. Asian sales by foreign affiliates of Australian companies could grow from $14 billion in 2013 to $78 billion in 2030.

3. Barriers to trade in services are more complicated and diverse than barriers to trade in goods. Foreign equity caps and market access restrictions on financial institutions are prevalent across Asia. Many countries limit flows of customer information and data to offshore holding centres. 'Behind the border' regulation, including onerous sector lending quotas or prudential requirements, constrain market entry or expansion. Regulation may cap the number of foreign directors, managers and staff of a foreign bank branch. Liberalisation of service sectors may be particularly sensitive because of national government goals to maintain control over key sectors such as banking.

4. The complexity of barriers to services trade means multiple strategies are needed. Bilateral and multilateral FTA negotiations will continue to be primary means to reduce 'at-the-border' barriers such as foreign equity caps and branch licence rules. This can build on the existing close cooperation between the Australian government and industry in identifying barriers and prosecuting the case for change.

5. In addition, government working with industry can build support for reform:

   a. seek consensus among regional governments for an APEC-based, or similar, agreement to promote services liberalisation

   b. promote greater mutual recognition of the domestic regulations in each country (e.g. risk management, consumer protection, privacy)

   c. promote the benefits of free trade in services for emerging economies, potentially by extending training in services trade

   d. develop a services liberalisation report card and increase data on services trade. This should include the offshore investment of Australian companies (mode 3 trade) since such investment is central to services trade.

6. ANZ has highlighted the bias against Australian investment in offshore businesses created by the tax system. Australian shareholders face a 30 per cent higher statutory tax rate on dividends sourced from foreign profits compared to domestic profits. This reduces incentives to invest in Australian global businesses. ANZ is making a submission to the Government's *Re:think* tax discussion paper on this issue.

A. INTRODUCTION

7. ANZ welcomes the opportunity to contribute to the Productivity Commission Review into Barriers to Growth in Australian Services Exports. Our presence in 33 countries and our 'super regional' strategy also means we are well placed to comment on barriers to the development of services trade.

8. ANZ employs over 49,000 people worldwide, 26,000 of whom are employed outside Australia. Within Asia, ANZ is represented in Cambodia, China, Hong Kong, India, Indonesia, Japan, Laos, Malaysia, Myanmar, the Philippines, Singapore, Taiwan, Thailand, Vietnam, and South Korea. ANZ is also represented across the Pacific in American Samoa, the Cook Islands, Fiji, Guam, Kiribati, New Caledonia, Papua New Guinea, Samoa, the Solomon Islands, Timor Leste, Tonga and Vanuatu.

B. BACKGROUND

Data on trade in services

9. Australia's services sector is the largest contributor to the domestic economy, employing nine out of ten Australians and generating 75 per cent of Australia's economic growth. The services sector is characterised by its heterogeneity; it covers professions ranging from software engineering to hospitality.

10. While the scale of the services industry in Australia is recognised, the role of services in our exports is less known. As noted in the April 2015 ANZ PwC Asialink Services Report, *Australia's Jobs Future: The Rise of Asia and Services Opportunity*, traditional trade data records that Australia's direct services exports (that is, cross-border trade and consumption abroad) were worth $50 billion to the Australian economy in 2013. These figures show that services contributed 17 per cent of exports, mining contributed 40 per cent and agriculture and manufacturing contributing the remaining 43 per cent.

11. However, traditional trade data only reflects part of the value of services exports to the Australian economy. Using a 'value-added' measure, the value of services exports is revealed to be significantly larger. A value-added approach measures both direct services exports and those services that are 'embodied' in goods exports. Embodied services include the transport, accounting, legal and all other services that contributed to the production of an exported good.

12. Using the value-added measure of Australia's exports, the Report finds that services contribute 41 per cent of exports while mining contributes 37 per cent. On this measure, services are Australia's largest export market.

13. Revenue from offshore investment by Australian companies ('foreign affiliates') is also not recorded in official trade data. *Australia's Jobs Future* estimates that foreign branches of Australian businesses generated revenue of $138 billion in 2013 – more than twice the value of direct services exports.

Which export markets are the most important

14. Asia is the growth engine of the global economy. The region's middle class is expected to grow from 500 million today to 3.2 billion in 2030. As the standard of living increases

across Asia, so will their demand for services. Australian services exports to Asia will also play a significant role in the economic growth and development of the region.

15. *Australia's Jobs Future* finds that Australia's services exports to Asia are relatively underweight compared to our services exports to the rest of the world. In value-added terms, services made up 34 per cent of all Australian exports to Asia in 2013. In the same year, services represented 54 per cent of value-added exports to the rest of the world. The earnings by foreign affiliates tell a similar story. As Asian economies mature, a growing share of economic growth will come from services, creating a significant opportunity for Australian services exports to Asia.

16. *Australia's Jobs Future* estimates that by 2030, Australia's annual services exports to Asia could be worth $163 billion – over a 135 per cent increase from 2013 – and support a million Australian jobs. The Report also finds that sales in Asia by foreign affiliates of Australian companies could grow from $14 billion in 2013 to $78 billion in 2030.

17. It is important to recognise that much of Australia's comparative advantage in services relative to Asia lies in highly skilled and qualified professionals such as lawyers, engineers, accountants and financial services. Exports of these services have the potential to boost both Australian growth, but also growth and economic development across Asia.

18. Services exports can also play a role in facilitating small and medium-sized businesses to export to new regions. The presence of a trusted bank or lawyer in a foreign market makes exporting easier for new entrants.

19. Unlike goods exports, services are not readily provided in a single cross-border transaction. Services businesses are often required to be embedded in the local market and culture to be a success. For this reason, services trade relies heavily on the establishment of branches or offices in local economies, rather than cross-border transactions.

C. BARRIERS IN AUSTRALIA'S KEY TRADE COUNTRIES

The nature of international barriers to trade in services

20. Barriers to trade in services are significantly more complicated and diverse than barriers to trade in goods. Services trade barriers range from market access to labour market and behind-the-border barriers such as regulation. Privacy, labour laws and banking regulation can also operate as barriers to services trade. Barriers will differ between countries depending on their level of openness, economic development and their model of their prudential and regulatory regime.

21. The main restrictions on service suppliers can be classified as limits on foreign direct investment, stringent licensing requirements and restrictions on expanding operations.

22. It may also be useful to refer to the OECD classification of types of barriers to trade, which they adopt in the Services Trade Restrictiveness Index (STRI). These are:

- restrictions on market entry

- barriers to competition
- restrictions on the movement of people
- other discriminatory measures (including discriminatory access to government networks or services such as payment systems), and
- regulatory transparency.

23. The OECD STRI for financial services highlights the effects of regulatory barriers preventing a service or service supplier's entry into a foreign market ('market access' barriers). In developing countries such as China, Indonesia and India, market access barriers are the single largest restriction on trade. Regulation preventing the establishment of a commercial presence in another jurisdiction represent a major barrier not just to Australian services businesses in the region, but also to the ability of the Australian 'brand' to establish a long-term footprint in Asia.

24. In more developed markets such as South Korea and Japan, barriers to competition represent a significantly larger portion of trade barriers.

Barriers to cross-border supply of services

25. ANZ operates a 'hubs strategy' for its Asia-based operations, including the storage of customer data. This strategy means that certain back-office operations across Asia are centralised in Manilla, Chengdu and Bangalore.

26. Many countries have restrictions on the flow of customer information and data to offshore holding centres.

    - For instance, Australia, China, Russia, and India have all passed laws to prevent personal information on their citizens from leaving these countries' borders. Australia prohibits the overseas storage of electronic health summaries for Australian citizens.
    - South Korea's *Personal Information Protection Act* restricts cross-border data flows. It requires companies to obtain consent from "data subjects" before data can leave the country. This act also requires data subjects to be informed of the recipient of their data, the recipient's use of the data, the period that information will be retained, and the specific personal information to be provided. The South Korean restriction on cross-border data flows with respect to Australia and the United States will be lifted because of Free Trade Agreements (FTAs), the restriction remains with respect to other trading partners.

Barriers to establishing a commercial presence in another country

27. A significant trade barriers faced by ANZ is the prohibition many countries impose on a foreign firm establishing or operating a branch or subsidiary in that jurisdiction.

Market Access

28. Foreign equity caps and market access restrictions for financial institutions are prevalent across Asia.

- *Foreign Equity caps*: Foreign equity caps are the primary barrier to accessing Asian banking markets. Such caps exist in many forms across the Asia Pacific region, and vary in their impact. For example, in China, there is a 20 per cent cap on foreign ownership of a domestic bank and a restriction of holding an interest in only two domestic banks, while Indonesia has recently implemented a 40 per cent cap unless a bank is deemed to be “fit and proper”.

- *Limits on Branch licences*: Countries will often apply a limit on the number of new branches for which a foreign bank may apply. Limitations on applications and issuing of bank licences for foreign banks are an obvious impediment to entering markets and slow down market expansion within the particular country.

- *Structure of operation rules*: Many countries will implement restrictions of how banks are to operate in their jurisdiction. Such restrictions may include requirements on where branches are to be situated and the proportion of funds to be directed towards certain sectors of the economy (e.g. small and medium business, or rural locations). These rules favour existing domestic banks and discourage new banks from entering the market

- *Product approval restrictions*: Limitations on the number of products approved, or the time in which they are approved, restrict the ability of a financial institution to access new or different sectors of a foreign market in a short time-frame.

‘Behind-the-border’ barriers

29. ‘Behind the border’ regulatory barriers can have a significant impact on the financial services sector and the broader services sector.

- *Regulator and Prudential Supervision*: Regulatory oversight and prudential standards, including depositor preference schemes and cross-border resolution schemes, differ greatly across jurisdictions in the Asian region. While these standards are in place primarily to ensure the stability of the domestic financial system and safety of creditors’ funds, such measures can restrict market entry. The General Agreement on Trade in Services recognises a “prudential carve-out” so that regulations to protect financial stability are not considered trade-restrictive. In some circumstances, prudential regulation can entrench existing domestic banks’ position or business model.

Barriers to the provision of services exports by natural persons

30. Local regulations in relation to banking services may come with restrictions on the directors, executives and staff of a foreign bank branch. These requirements, which differ across jurisdictions, will require that a given number of directors or senior staff to be local citizens. These requirements limit banks’ ability to staff foreign branches or subsidiaries with appropriate and skilled staff. They also inadvertently reduce the ability of a new entrant to train local staff and contribute to skill development in the local economy.

Other barriers

31. Services trade can also be inhibited by informal trade barriers that are not necessarily due to direct government regulation or intervention. Cultural understanding and linguistics, legal systems and land title can present a significant impediment to market

entry. These factors may be considered as ‘developmental issues’ in that they can be related to the pace and stage of economic growth, maturity of regulatory system, and the degree of cultural ‘openness’.

D. REDUCING BARRIERS TO SERVICES EXPORTS

32. The complicated nature of services trade barriers means that there is no single strategy for advancing liberalisation. The barriers to trade in the services industry are an inherently different and more diverse than those that limit goods trade.

33. Negotiations about service sector liberalisation can be particularly sensitive. Governments may seek to manage foreign investment in sectors such as banking and financial services carefully. Governments may have policy goals to promote rural banking or small business development that impact on market entry.

34. Bilateral and multilateral FTA negotiations remain the primary means to addressing ‘at-the-border’ barriers such as foreign equity caps and branch licence rules. ANZ works with DFAT to negotiate changes to these laws. We acknowledge DFAT’s extensive work and welcome the continued support of the Australian government and agencies in this area.

35. ANZ believes a stronger agreement between countries in the region to support more liberal services trade and align regulatory structures would be valuable. A general understanding or agreement between countries, which sets a long-term aim of greater services liberalisation, could underpin and guide further negotiations. This could be done through APEC.

36. Barriers often arise because the local regulation differs from Australian or international approaches. Mutual recognition of regulations can reduce costs and barriers to entry. Recent FTAs with South Korea and Japan have achieved significant gains by improving clarity and strengthening regulator consultation. Further work to promote mutual recognition would be valuable. This might include identifying best practice regulations or information sharing, as well as strengthening long-term government-to-government and regulator-to-regulator relationships.

37. The Australian government and business have an important role in promoting services liberalisation. There is considerable activity promoting the benefits of liberalisation within Australia but less attention on similar activity in the region. Australia has previously supported trade-in-services training programs for government officials around the region. This could be a means of promoting services liberalisation to our trading partners while also improving the regional government skills and capabilities.

38. Increasing the availability of data on the depth of services trade and liberalisation of services markets in Asia would be helpful. For example, an accessible ‘report card’ on progress in services liberalisation and current status would help focus policy. This should include the offshore investment of Australian companies (mode 3 trade) since such investment is central to developing services trade.

E. TAX AND AUSTRALIAN INVESTMENT IN OFFSHORE BUSINESSES

39. The Productivity Commission issues paper notes ANZ's concerns about the impact of Australia's tax system on offshore investment. Australian shareholders face a 30 per cent higher statutory tax rate on dividends sourced from foreign profits (irrespective of the countries into which investments are made) compared to domestic profits. They do not receive the equivalent of a franking credit.

40. This creates a bias against Australian shareholders' investment in offshore businesses and limits our opportunity to take advantage of the growth of Asia. It results in a concentration risk for Australian investors and reduces risk-adjusted returns.

41. Australian investors will as a result be likely to place a lower value on foreign assets or income streams than foreign investors who generally face a much lower tax rate on such dividends. It creates an incentive for the foreign assets of Australian companies, or businesses that operate predominantly offshore, to pass into the hands of offshore investors.

42. This bias does not exist at the company level. Australia and most other OECD member countries do not tax the profits of foreign subsidiaries (provided a subsidiary is not located in a tax haven) because those profits have already been taxed by the host country. This is a desirable feature of the Australian tax system that should be maintained.

43. The bias against investment in Australian-based companies with offshore business is important:

- Global trade is becoming based around business investments and local market presence rather than traditional exports of goods. This is particularly so for services such as health, communications and finance.
- Australia is a relatively small economy. Australian companies need to invest outside Australia to grow and successfully compete against global companies with scale or specialised capabilities.
- Income from offshore investment is an important means of diversifying the economy, reducing fluctuations caused by commodity cycles.
- Economic research shows that businesses with high levels of offshore foreign investment make a strong contribution to the home economy. They are associated with particularly high levels of investment, research and development activity and high value employment. They are vehicles for commercialising scientific and technical research. Offshore investment results in higher domestic growth, and is not a substitute for home country investment.

44. While there are many examples of successful Australian companies, Australia as a whole has relatively low levels of outgoing foreign direct investment compared to other OECD member countries.

45. ANZ is currently finalising a detailed paper on these issues that it will publish in the coming months. We will also make a submission to the government tax discussion paper, *Re:think*, on these issues.