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Overseas Investment: is New Zealand ‘Open for Business’?

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*Corrected July 15, 2010 to repair the inadvertent omission of Figure 1.

Executive Summary

The economic purpose of an Overseas Investment Act should be to enable foreign investment that has a positive (or at least non-negative) impact on a country's economic performance, and to prevent investments which will likely have detrimental net effects. An examination of both the content and application of the New Zealand Overseas Investment Act 2005 finds that it is not well-aligned with this purpose.

The Act's stated purpose is "to acknowledge that it is a privilege for overseas persons to own or control sensitive New Zealand assets". Consequently, the Act focuses principally upon identifying those New Zealand assets qualifying as "sensitive", defining who qualifies as a "privileged" overseas investor, and the specific terms of transactions under which ownership and control of sensitive assets transfer to overseas persons.

In determining what constitutes a "sensitive" asset, the Act makes a largely arbitrary distinction based on the nature of any land involved in the transaction (either the sale of the land itself, or the sale of shares in a business with an interest – such as leasehold – in land deemed "sensitive"). The definition of "sensitive land" encompasses a very large proportion of New Zealand's territory, including farm land, any land subject to conservation or heritage orders, non-urban land in excess of 5 hectares, land in excess of 0.2 hectares adjoining the foreshore or land in excess of 0.4 hectares adjoining a lake, reserve, heritage or conservation land or adjoining land subject to conservation or heritage orders.

Where no land deemed sensitive is involved in proposed acquisitions by overseas persons of significant business assets, a test requiring only minimal screening of the investor's character is applied. Consequently, foreign investment in significant New Zealand businesses with no sensitive land holdings, that could have a detrimental effect upon the New Zealand economy, can proceed without any check being undertaken of likely economic consequences. Conversely where sensitive land is involved – even if it is peripheral to the transaction and its use is unlikely to change as a result of the change in ownership – then the Act requires the transaction can proceed only if there are strictly positive benefits (or in many instances, a higher standard of "substantial and identifiable" positive benefits) to New Zealand. While the required process for the assessment of benefits might appear similar to a standard cost-benefit analysis, the Act excludes some relevant costs and benefits, and permits arbitrary weighting by the decision makers of the costs and benefits actually considered.

An examination of published decisions under the Act shows that in practice, the determination of benefits to the New Zealand economy excludes consideration of substantive private gains accruing to New Zealand vendors as a consequence of the transaction proceeding. Consequently, potentially beneficial transactions can be refused, with attendant negative flow-through consequences: disincentivising both foreign and local investment, locking the existing owners into owning firms that they value less highly than alternative potential owners and thereby depressing the firms' long-term economic performance and value, the detriments of which accrue to their existing owners.

The design and application of the Act thus imposes substantial disincentives to both foreign investment in New Zealand firms, and New Zealand investment in firms that might ultimately be sold to foreign interests. These disincentives will be reflected in lower prices paid for New Zealand assets (both businesses and sensitive land) when they are traded, less frequent transacting in the market for such assets, and fewer firms created in New Zealand where sensitive assets may be involved.

Widening the scope of benefits considered in assessing foreign purchase proposals to include private gains to New Zealand shareholders and allowing sales to proceed when the likely benefits to New Zealand are not negative (rather than strictly positive) will result in a better alignment of the incentives for both buyers and sellers to engage in welfare-enhancing trade of shares and improved capital markets performance, whilst still precluding investment where this would clearly be deleterious to the national economic interest. Bringing economic tests into line with standard cost-benefit analysis, including correct specification of the counterfactual and non-arbitrary weighting of costs and benefits would reduce the probability of welfare-reducing decision being made, improve the transparency and predictability of the Act and reduce transaction costs.

Such changes, however, do not address the fundamental conflict between policies seeking increased foreign investment for economic purposes, and the application of the Overseas Investment Act for the largely non-economic purpose of retaining New Zealand control of narrow classes of assets, such as those described as "strategic infrastructure". If ongoing New Zealand control of these assets is considered essential to the national interest, then regardless of the economic consequences that this may impose, it may be more appropriate to explicitly separate out such assets for consideration under separate, explicit ownership controls. This would allow the Overseas Investment Act to be more appropriately and explicitly directed towards national economic imperatives with respect to the very much larger class of non-strategic infrastructure assets.

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1. Introduction

In March 2009 the New Zealand government announced that a review would be undertaken on the Overseas Investment Act 2005 (OIA)¹. The review follows the high-profile Ministerial decision in 2008 which denied the shareholders of Auckland International Airport (AIA) permission to sell shares to the Canadian Pension Plan Investment Board (CPPIB). The AIA decision has been the subject of much criticism, generating many suggested changes to the OIA (e.g. Chapman Tripp, 2009; The Treasury, 2009; Simpson Grierson, 2009; Hanson, 2008; Capital Market Development Taskforce, 2009).

This paper considers the basis of New Zealand’s foreign investment controls by analysing the economic objectives of pursuing overseas² investment, the reasons why a sovereign government may wish to intervene in overseas investment transactions, and the content and application of New Zealand’s OIA as a means of governing the overseas investment process in the pursuit of economic objectives. The paper begins (Section 2) by addressing the property rights associated with the ownership of shares in companies, the motivations for owners to trade the shares, the economic reasons why a sovereign government might want to place restrictions upon the sale of shares to foreign investors or prevent foreign investment in start-up ventures and the appropriate tests and benchmarks that should be applied to determine whether a proposed transaction will likely result in net economic benefits. Section 3 examines the provisions of the New Zealand OIA, and their consistency with the economic expectations for such legislation. Section 4 examines the application of the OIA in relation to four recent cases: the AIA-CPPIB transaction, the sale of Vector Wellington Electricity Network to Cheung Kong Infrastructure (CKI), the proposed sale of New Zealand Steel Mining Limited to CKI and the purchase of a small section of farm land near Taihape. These cases enable assessment of the consistency of the application of the Act with both its conceptual objectives and its specific provisions.

The analysis indicates that the New Zealand OIA and its associated processes are not well-aligned with the objective of enabling foreign investment with the purpose of increasing New

¹ <http://beehive.govt.nz/release/government+simplify+foreign+investment+rules>. Accessed 2 June 2010.

² The terms “overseas” and “foreign” are synonymous in the context of an island nation such as New Zealand. The terms are used interchangeably in this paper.

Zealand's economic potential or actual economic performance (Section 5). Rather, the starting point for the Act is the presumption that it is a privilege for overseas persons to participate in the ownership and control of "sensitive" New Zealand assets. Consequently, the OIA is concerned principally with managing the process via which individual overseas persons are allowed to invest in a subset of assets deemed "sensitive", rather than taking account of the wider economic implications of the transaction for the national economy. Moreover, different standards are applied to screening investments depending on the size and other characteristics of any land associated with the asset. Whilst overseas purchasers of "significant" business assets are subject only to tests of their "good" character, transactions involving the sale to foreign investors of land deemed "sensitive" (or businesses with an interest in "sensitive" land) are subject to a set of statutory and regulatory criteria of both an economic and non-economic nature.

In practice sensitive-land sale transactions³ are allowed to proceed only if it is deemed, on the basis of an apparently narrow interpretation of the statutory and regulatory criteria, there is a net benefit to New Zealand. A peculiar feature of the 'net benefit' calculation is the apparent exclusion from the assessment of gains that would accrue to private shareholders (either New Zealand or foreign) if the transaction proceeded. Successful applications must demonstrate the presence of other co-incidental (i.e. spill-over) benefits accruing to New Zealand in order to justify approval of the transaction. Consequently, transactions where the benefits accrue as purely private benefits to New Zealanders are not approved, even though the anticipated private benefits that must be forfeited when the transaction is denied may be very substantial. Furthermore, when the firm is already foreign-owned, the absence of both private New Zealand benefits and spill-over benefits accruing to New Zealand will preclude the granting of permission for a sale to proceed. Consequently, an unwilling foreign owner is locked into continued ownership of an asset more highly valued by another foreign party, even though there is no demonstrable net detriment to New Zealand from the transaction proceeding. The exclusion of private benefits from consideration results in the Act posing substantial disincentives for both foreign investment in New Zealand firms and New Zealand investment in firms that might in the future be sold to foreign interests. These disincentives will be reflected in lower land valuations and share prices and reduced liquidity in the market for shares in New Zealand firms, which of themselves are a net detriment to the New Zealand economy.

³ The term "sensitive-land transaction" in this report is used to mean a transaction subject to S.12 of the OIA. In simple terms, this includes the sale or long-term lease of land deemed sensitive (Schedule 1) , and/or the sale of an interest in a firm that owns or leases sensitive land.

Our analysis suggests that widening the scope of benefits considered in assessing foreign purchase proposals to include private gains to New Zealand owners and allowing sales to proceed when the gains to New Zealand are not negative (as opposed to the current test of strictly positive) will result in better incentives for both buyers and sellers to engage in welfare-enhancing trades and improved capital markets performance, whilst still precluding investments where this would clearly be deleterious to the national interest.

It is acknowledged that there may be some assets which, for non-economic reasons, it may be undesirable for foreign entities to take a controlling interest (for example, iconic or historic New Zealand sites, strategic defence locations or other assets deemed sufficiently strategically important that foreign ownership is undesirable). If New Zealand ownership and/or control of these assets is sufficiently strategically important as to warrant specific exclusions from increased foreign ownership, it may be more appropriate to separate out such assets for consideration of separate, explicit ownership controls rather than applying the OIA to discourage such transactions on a case-by-case basis. Such separation of “strategically important” assets from other tradeable assets would provide clarity for current and potential owners about which assets may be freely traded with foreign investors and which may not. Removing uncertainties about the nature and identity of these assets would allow the design and implementation of the Overseas Investment Act to be more appropriately and explicitly directed towards furthering national economic imperatives rather than addressing other, non-economic, concerns.

2. Firm Ownership and Government Interest in Foreign Investment

“Economic growth will occur if property rights make it worthwhile to undertake socially-productive activity” (North & Thomas, 1973).

The institution of ownership, accompanied by secure property rights, is the most common and effective institution for providing incentives to create, maintain and improve assets (Milgrom & Roberts, 1992). Assets have a bundle of legal rights attached to them, and all or a subset of rights may constitute ownership. However the concept of ownership as it is commonly used is associated with a bundle of property rights associated with an asset: to occupy and use the property (asset), to enjoy the income generated from the legally permitted uses of the property, to exclude others from using the property, and to transfer some or all of the property rights associated with the asset to other owners and for whatever consideration is available (Hansmann, 1988). In practice it is the last of these rights that most clearly defines ownership, since ownership can be retained even where use and exclusion rights are transferred, for example through a lease, or impaired by government action (Evans, Quigley & Counsell, 2009). These principles apply regardless of the nature of the property concerned – be it a physical asset (e.g. land), an intangible asset (e.g. a patent) or a claim to an interest in a bundle of physical and/or intangible assets (e.g. shares in a firm).

Statutory provisions in legislation can be used to create an additional property right, vested in a third party, granting that party the ability to restrict the extent to which the owners of the remaining rights can freely exercise the right to transfer any or all of the rights to whomsoever they choose, for whatever consideration is available. Effectively, the third party is granted an option (property right) to intervene in a transaction where specified rights are traded, taking away freedom of choice from the remaining rights-holders. Such impositions constitute a ‘taking’ that devalues the remaining rights compared to the counterfactual of unrestricted choice. The exercising of these rights by third parties thus has an unequivocally negative consequence for the remaining rights-holders. The use of executive power to create such third-party rights, and the exercising of the option to intervene that is created, has significant economic consequences for the holders of the remaining rights. Such power should therefore be used very sparingly and in full cognisance of its likely effects. A net gain from such intervention will accrue only when the intervention results in a gain sufficiently large to compensate the losers and leave all rights-holders in total no worse off than if the intervention had not occurred, and with compensation able to be paid to the losers in order to preserve the incentives for efficient investment in assets to which the property rights pertain (the Kaldor-Hicks criterion - Kaldor, 1939; Hicks, 1939).

2.1 Gains from trade

When property rights are clearly defined and enforceable, and individuals are able to bargain together effectively and enforce their agreements, then the property rights will be exchanged in such a manner that they will end up being owned by the individuals whose ownership confers the greatest total economic value to society as a whole (Coase, 1960; Williamson, 1985). No seller will willingly trade the rights unless the compensation paid exceeds the value placed on owning the right; no buyer will willingly pay a price higher than that at which he values owning the right⁴. Voluntary trade realises a welfare gain to society, as a buyer with a higher valuation of the asset pays a vendor with a lower valuation a price that exceeds the vendor's valuation. When buyers and sellers bargain freely, they will distribute the gains of trade between themselves in a mutually-agreed manner. The price struck leaves the buyer with a surplus measured by the difference between the value of the right owned by him and the price paid; the vendor's surplus is the difference between the price paid and her valuation of the right when owned by her.

In most circumstances, the private gains from trade which accrue to the buyer and seller directly are the only consequences arising from the transaction. When buyers and sellers can freely trade, the economy as a whole will grow as buyers and sellers, with full information about the values they place upon owning the rights, will willingly engage in those trades that maximise their own personal positions. These principles underpin the concept of free trade (Smith, 1776; Samuelson, 1937).

However, it may be that the transaction imposes additional costs or benefits upon third parties (externalities) that are not taken into account by the buyer and seller when deciding to transact⁵. Two cases warrant attention:

- If the external benefits are large, but there is no private benefit to either the buyer or the seller, then even though it would be desirable from the wider economic perspective for the transaction to go ahead, the buyer and seller will not willingly interact. Intervention may be necessary to enact the trade for the net benefit to be yielded.

⁴ This principle was first described by Aristotle (Soudek, 1952).

⁵ *Positive externalities* (or *spill-over benefits*) are benefits that accrue to third parties as a result of a transaction, for example access to improved infrastructure. Similarly *negative externalities* are costs imposed on third parties, for example increased noise or pollution.

- If the private benefits are substantial enough to motivate the parties to trade, but the transaction imposes external costs that exceed the sum of the private and external benefits, then unless the trade is prevented, the total size of the economy (net welfare) will decrease. For example, a transaction resulting in the creation of market power that will unequivocally be exercised to the detriment of consumers would require intervention (e.g. the use of merger control regulations) to prevent a net loss to society.

It is the second of these cases that is of interest in the context of inward foreign investment.

2.2 Criteria for Government intervention

Governments are typically charged with furthering the economic interests of their nations. At the very least, governments seeking to ensure that the economies in their stewardship have the best possible opportunities to grow as a consequence of welfare-enhancing trades have a legitimate role in protecting property rights and the ability of rights-holders to freely trade with each other. Generally, the interests of both individuals and governments are served best when governments provide a sound and secure legal framework via which such trades can be conducted, and refrain from intervening in individual transactions. However, governments may deem it legitimate to grant themselves the right to intervene in private trades when it is clear that the external costs exceed the sum of private plus external benefits. Intervention could take one of two approaches⁶:

- (a) screen proposed transactions and block proposals assessed to have negative outcomes; or
- (b) identify transactions which caused negative outcomes, and reverse those transactions or otherwise act to ameliorate the outcomes.

If the reversal of transactions or amelioration of effects is likely to be difficult then a transaction screening mechanism is indicated.

Where both the buyer and seller are subjects of the same government and all of the external effects pertain solely to the economy stewarded by that government, the legitimate exertion of intervention rights when the costs clearly exceed the benefits is generally uncontroversial. However, national economies are very rarely closed systems. Buyers and sellers may be subjects of different sovereign governments and both the positive and negative externalities

⁶ A third approach is to implement taxes or other policies in such a way as the private parties internalise external costs in their decision-making. To the extent this approach is successful, intervention in individual transactions will be unnecessary.

arising from trade may impact differently upon the economies of the countries of the traders concerned or even have a material effect upon unrelated economies. When at least one of the parties to the transaction is not a subject of the government in question, the possibility arises of the transaction having a net negative consequence upon the economy over which that government has stewardship. A prudent government wishing to be satisfied that these circumstances do not arise may implement a transaction screening mechanism. The question emerges of what factors a government should take into account when assessing the costs and benefits of a proposed transaction and making the decision of whether or not to intervene in an agreement to trade reached, in unconstrained circumstances, between the private parties. Evans (2004) makes the case for total surplus (economic efficiency) being the appropriate criterion to be applied.

As a government is charged with the stewardship of the economy of only its own state, then the relevant costs and benefits to consider are those affecting only the economic interests of that state⁷ – expressed as the cumulative interests of its subjects, both individual and corporate, and externalities arising from the transaction. The relevant *private* benefits and costs arising from the trade are those pertaining specifically to the state’s residents (individual and corporate) involved in the transaction. When a resident purchases an asset from a non-resident (e.g. purchase of an imported good) then the surplus enjoyed by that resident (benefit received net of price paid) enters the local economy as a positive benefit. When a resident sells an asset to a foreign party (e.g. an export sale, or foreign investment in a New Zealand capital asset) the private surplus (sale price net of cost of production) likewise enters the local economy as a positive benefit. The relevant *external* benefits and costs to the subject economy are those that impinge upon either its physical territory (i.e. land) or non-transacting residents (individual or corporate) separate from the private benefits enjoyed by the transacting parties. The relevant *social* benefits and costs are the sums of the relevant private and external benefits and costs respectively.

If the effect of externalities on the local economy is positive or neutral, then regardless of the size or locus of the private benefits, there would appear to be no justification for intervention, as there is no harm done to the local economy as a consequence of the transaction proceeding that would justify government intervention (providing it can be assumed that residents do not willingly engage in trades that for whatever reason lead to personal losses).

⁷ Concerns for ‘fair trade’ and overseas development may create an interest within a country for consideration of the costs and benefits incurred in other countries as a result of foreign investment transactions. Such concerns are more relevant to outward foreign investment and thus outside the scope of this paper.

This leaves as candidates for intervention only those cases where the transaction imposes a net external cost on the local economy. However, a net external cost is of itself insufficient to prevent the transaction from occurring without considering the extent to which private gains may exceed the external costs. If the magnitude of the net external cost to the local economy exceeds the net gains accrued by transacting residents, then it is in the interests of the local economy for the transaction to be prevented⁸. The Kaldor-Hicks criterion suggests the transaction should proceed, as the local economy post-trade is still larger than pre-trade local economy. Within the restricted local economy those making private gains could, in principle, compensate the losers and still be better off. To prevent a transaction from occurring simply because a net negative externality exists imposes a much stricter test – that the transaction must leave at least one set of residents better off (i.e. the resident transacting party) but no other residents less well-off (i.e. those bearing the cost of the externality, even though they are not parties to the transaction), regardless of the feasibility of the ‘winners’ being able to compensate the ‘losers’.

If it were possible to measure the incidence of loss incurred, and feasible for the ‘winners’ to make a compensatory transfer to the ‘losers’, then it is welfare-enhancing for the transaction to proceed, regardless of the presence of the negative externality per se. However, measurability and the nature of the gains and losses mean that such transfers are not always feasible. In such cases, the government may deem it desirable to prevent the transaction in order to avoid creating losers who cannot be compensated. However, in intervening to prevent the transaction from occurring, losers are inevitably created in the form of those who would have received private gains had the transaction proceeded. Such interventions thus have an explicit distributional motivation – in effect a ‘taking’ from the prospective ‘winners’ (gains foregone) in order to avoid a loss imposed upon the prospective ‘losers’.

It is noted that whilst in principle the assessment of costs and benefits appears straightforward, in practice it is made more complex by the ability to obtain the necessary information to make an accurate assessment, the uncertainties associated with likely and/or merely possible future outcomes and the extent to which the relevant costs and benefits may affect individual residents differently and thereby influence the incentives facing the decision-makers. Any or all of these factors may result in a less-than-optimal assessment, leading to decisions that prevent the national economy realising its full potential.

⁸ Although it is noted that such a stance violates the principles of free trade across borders as it ignores the private benefit to the foreign transactor – free trade being aligned with the maximisation of the universal economy.

Box 1 contains a summary of the costs and benefits in cross-border transactions.

Box 1. Summary of costs and benefits in cross-border transactions

The diagram illustrates the classification of costs and benefits in cross-border transactions. It is structured as follows:

- Total welfare:** The overall category, represented by a red rounded rectangle at the top.
- Local welfare:** A green rounded rectangle on the left side, encompassing categories A and C.
- Gains from trade:** A purple rounded rectangle on the right side, encompassing categories B and D.
- Categories:** Four blue boxes are arranged in a 2x2 grid:
 - A. Private Local:** Private benefits within the local territory.
 - B. Private Overseas:** Private benefits outside the local territory.
 - C. External Local:** External costs within the local territory.
 - D. External Overseas:** External costs outside the local territory.

Costs and benefits can be classified by who they affect: parties who are part of the transaction (*private*) and those who are not (*external*). They can also be classified by geographic locus: within the territory concerned (*local*) and outside that territory (*overseas*). The blue boxes above represent the four combinations of these classifications.

A transaction will voluntarily occur if the private benefits (gains from trade) for both vendor and purchaser are greater than zero (boxes A and B).

The transaction will be welfare-enhancing in total if social benefits (private plus external) exceed social costs (boxes A-D).

From the perspective of the local territory, a transaction will be locally welfare enhancing if benefits accrued locally exceed costs incurred locally (boxes A and C).

The threshold for consideration of local screening is reached if external costs incurred locally exceed external benefits accrued locally (box C). However, if local benefits exceed local costs (boxes A and C), the transaction should be allowed to proceed (using the Kaldor-Hicks criterion), as the private ‘winners’ can theoretically compensate the external ‘losers’ and still be better off than if the transaction had not occurred.

2.3 Transaction efficiencies

If government intervention is justified in order to avoid potential adverse consequences, then the question arises as to what is the most appropriate mechanism for intervention. Mechanisms available to restrict foreign investment include monopoly government ownership of specific sectors (e.g. the electricity transmission grid in New Zealand), restrictions on the proportion of shares in locally-listed companies that can be owned by foreign investors (as has applied in the past in Finland), restrictions on the identities of land owners, and control rights held by governments and written into the constitutions of companies (e.g. Air New Zealand). Broad screening mechanisms on investment transactions such as the Overseas Investment Act have the advantage of being comprehensive and difficult to avoid, and may be appropriate when it is difficult to determine in advance the sectors in which adverse consequences will occur.

Screening mechanisms do create delays and transaction costs and increase uncertainty for all participants. These costs are incurred for transactions whether approved or declined, and are a real cost to the economy. Costs can be significantly reduced if the process is transparent, criteria clear and outcomes predictable, including rights of appeal and review⁹. A well-designed screening process should exhibit these characteristics.

2.4 Incentive effects of interventions

Whilst the appropriate criterion for government interest in a transaction is the presence of external costs to the economy in question, interest should lead to intervention only in that subset of cases where the net external costs exceed the net private benefits (Box 1). It is therefore critical to the assessment that the full range of costs and benefits and their locus of effect be identified. Failure to include the full extent of the private benefits may lead to too much intervention, with negative consequences for the size of the national economy.

Assume, for example, only external costs and benefits are considered when the government makes a decision to intervene (i.e. private benefits are ignored) in a transaction where a resident sells shares in a local firm to a foreign investor. The foreigner is the person with the highest value of the shares; all other potential purchasers, both local and foreign, value the shares much lower than the foreigner¹⁰. A transaction with very large private benefits and

⁹ Rights of appeal and review will, over time, increase the transparency and predictability of the application of a law.

¹⁰ There are a number of reasons why a foreigner might have the highest valuation of the shares. These include opportunities for diversification (Ariff & Khan, 1998), or simply that given a random distribution of valuations, the holder of the highest valuation is most likely to be from outside a small economy. Reasons for wanting to purchase 100% control of a business include vertical integration (Hart, 1989), economies of scale and scope, and control of assets for strategic purposes.

very small external costs will be prevented from occurring, even though the net effect would have been substantially positive for the local economy.

Vetoing a transaction to sell to a foreign investor simply because there are no external benefits accruing to that territory will have a depressing effect on the expected returns to residents from investing in assets in that territory in all future investment decisions undertaken. A government veto signals that the local owner can expect to deal with only the highest-valuing resident of the same territory when any future decision is made to sell the asset. Due to the necessarily smaller subset of candidate purchasers, the return from this future transaction will be smaller than that obtainable from selling in the open market. Thus, the expected value of the shares transacted in the local market will be lower than if they can be freely traded with all prospective purchasers. This is consistent with observations that otherwise identical shares which can be sold to foreign investors trade at a significant premium above those which can only be sold to domestic investors in Finland (Hietala, 1989), Thailand (Choi & Clovutivat, 2004) and other countries (Bailey, Chung & Kang, 1999). A reduction in a firm's share price increases its cost of capital, raising the hurdle rate for new productive investments by that firm. This could be expected to inhibit investment by local firms.

Furthermore, it is also likely that the returns from the future sale will be less than the return available from other investment opportunities available to a local resident with funds to invest. Consequently, local investors may eschew purchasing shares in local firms – favouring offshore opportunities that offer greater expected returns. Both returns and liquidity in the local share market are consequentially reduced.

Moreover, the incentive for local residents to create firms in the local economy will be substantially reduced, with the effect being greater the more likely it is that the highest valuing potential buyer for the shares in a future trade is foreign. All else equal, the firm founder will prefer to establish the firm in an economy where asset trading is less restrictive. Economic benefits arising from that firm are forfeited by the local economy: there will be fewer local firms than if the foreign investment restriction was less severe.

2.5 Uncertainty and assessment of intervention

When assessments are made of the effects of a transaction, there will necessarily be uncertainties involved regarding the magnitude of the gains and losses occurring. As all transactions are made on the basis of the expected costs and benefits over a future time

horizon, the actual outcome will depend upon factors that cannot be anticipated or controlled by either party (e.g. worldwide financial conditions, physical disasters such as earthquakes).

Both the expected costs and benefits, and their variances, must be taken into account, in order to determine a realistic expected value and the probability of it being realised.

2.6 Choice of counterfactual

When making an assessment of the effects of an intervention, it is important that the base case against which the transaction is assessed is selected appropriately. The simple fact of proposing a transaction has an important informational effect that alters expectations of all parties as to the value of an asset. If the transaction proceeds, the vendor will accrue gains equal to the difference between the price paid and reservation value. Likewise, making a decision to prevent the transaction occurring alters the information available to current and potential future owners of the expected value of the asset. A rejection signals that the set of potential future purchasers of the asset is constrained to exclude foreigners, consequently lowering the price that remaining interested purchasers may be willing to pay.

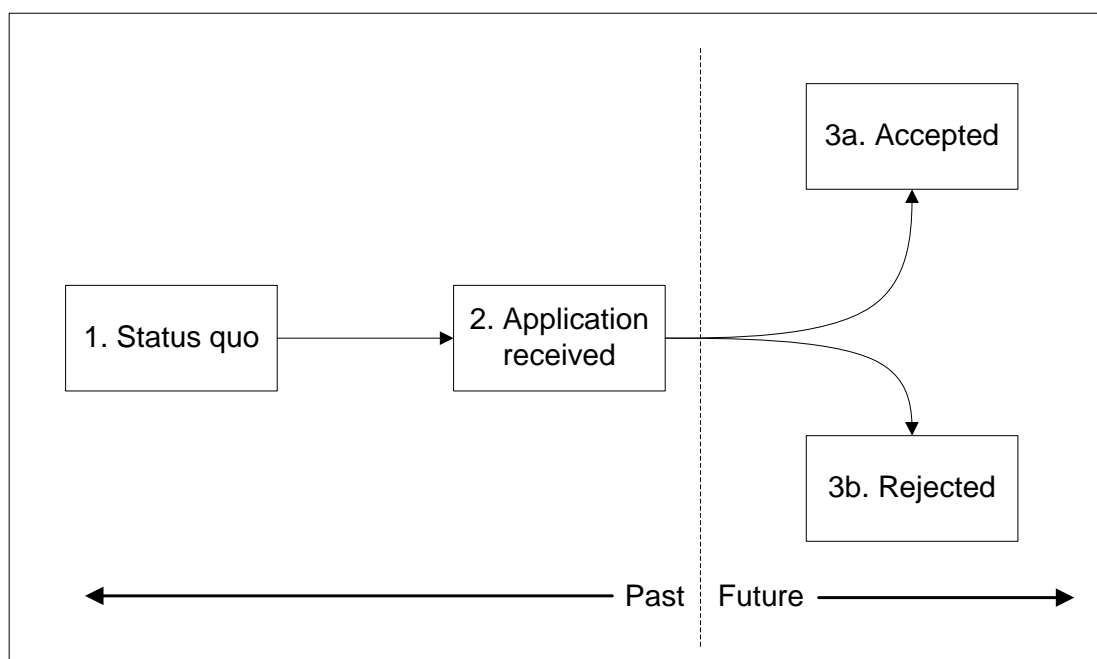


Figure 1. State diagram for screening process decision-making

The importance of choosing the appropriate set of values upon which to base the assessment of the transaction's costs and benefits (the counterfactual) is illustrated in Figure 1. Once an application is received and a decision is pending (the dotted line in Figure 1), decision-makers are logically tasked with deciding on the better of two alternatives: rejection or acceptance. This is true even if both of those states are themselves worse than the original status quo –

that state is now “sunk” in the sense that it can never be regained. The appropriate reference point (counterfactual) for the calculation of the relevant costs and benefits upon which to base the decision is not the status quo that prevailed before the application was received (as this state is past and can never be recovered) but the rejection of the application, as this is the state that will actually prevail.

2.7 Externalities and land

A sovereign government may take a greater interest in transactions that involve land physically located within its jurisdiction than those where land is not involved. It is understandable that such a view may be taken because, regardless of the identity of the transacting parties, the land remains within the local economy. A particular concern pertains to externalities associated with foreign control of the land. These may be uncertain at the time of the transaction, but could come to pass in the future. The externalities concerned are those that pertain strictly to the ‘foreign’ identity of the ownership and control interest¹¹, and not those that may arise regardless of the identity of the owner (for example, changes in technology enable new uses for the land to emerge that make the land subsequently more valuable to the new owner, but which being unforeseen were not factored into the price paid to the vendor¹²). Furthermore, they must be genuine externalities and not simply the creation of a means to limit the rights of foreign owners to change the use of the land in response to changing economic circumstances, which are more appropriately managed by other land use restrictions that operate without regard to the identity of the owners. Changes in land use are more appropriately controlled by resource management and local body consenting processes than by an overseas investment screening mechanism.

As the land cannot be moved from the territory, the externality risks associated with its ‘foreign ownership’ may not be easily diversified away from the local economy. This could become an issue, for example, where there is a shared complementary asset associated with land (such as a brand), and an increased risk that foreign owners might undertake behaviour that damaged that complementary asset. This arguably applies in the case of dairy farms in New Zealand (see Box 2).

¹¹ While the authors had some difficulty in thinking of an example of such an externality, The Treasury (2004) provides the following observation: “overseas investors can create domestic problems if they behave in a manner that is inconsistent with domestic behavioural norms, even if such behaviour is not illegal. Examples of such behaviour may include restricting access across a property where it has been traditionally granted.” (p.15) A further example is discussed in Box 2.

¹² It is noted that historically, sovereign governments have used their legislative powers to create monopsonies that have enabled their purchase of land at less than the fair market price, for example the Crown purchase of Maori land in colonial New Zealand (Evans, Counsell & Quigley, 2009; Boast, 2008).

Box 2. Externalities and the ownership of New Zealand dairy farms

The dairy farming industry provides a possible example of undiversifiable externality risks associated with land ownership. A purchaser of a dairy farm is also purchasing a stake in a complementary asset: the New Zealand dairy brand with associated values of product quality and (relatively) clean production. While presumably the purchase price paid will include a capitalised premium reflecting the value of this brand, there may be an incentive for a reduction in product quality or production standards that generates a private benefit greater than the private loss from a reduction in the owner's share of the complementary asset. This is the incentive structure that creates the 'Tragedy of the Commons' for common-pool resources described by Hardin (1968). Degradation of the NZ dairy brand would concern the government as the dairy sector is a large and important part of the economy and an important contributor to the overall 'Brand New Zealand'. An adverse impact on the dairy brand could thus have spill-over costs in other agricultural sectors and the tourism industry. The government has a stewardship role over the country's brand, and associated risks are difficult to diversify.

However, both local and overseas owners may face incentives to degrade the brand. Regulation of minimum standards for animal husbandry, environmental protection and integrity of the food production chain are an important counter to these incentives, and to the extent that such regulation is effective it will mitigate brand risks regardless of owner nationality. Brand degradation incentives are likely to be stronger for investors with shorter investment horizons, those with a smaller stake in the New Zealand economy as a whole and those who feel reduced pressure to conform to societal norms. If those factors are more applicable to overseas investors than local ones, and the potential externality damage is significant, then there may be grounds for screening proposed overseas investments in dairy farms. Under these circumstances, the government should look more favourably on larger, longer-term investments relative to smaller, shorter-term ones.

Making assumptions about future behaviour based on the identity of an owner is a form of discrimination, and inappropriate and counter-productive discrimination may occur from a desire to keep a common-pool resource in local ownership (Ostrom, 1999). It may be equally valid to assume that foreign owners are more likely to have knowledge of local demand factors in key overseas markets, relationships that enable entry into new markets, and experience with farming techniques that could be profitably applied in New Zealand.

Overseas ownership of New Zealand farms could thus generate both positive and negative externalities, and it would be unwise for decision-makers to jump to conclusions without further detailed consideration of each specific proposal.

Whilst these uncertainties may result in either positive or negative consequences, an extremely risk-averse government could be concerned that the possible negative externalities associated with foreign ownership of the land, if they should come to pass, may be untenable. This may lead such a government to veto all transactions where there is even a small probability of such an eventuality occurring at some time in the future, regardless of the possible positive consequences that might otherwise be realised. However, if such an approach is taken, both certain private gains and possible positive private gains and externalities are ruled out, and the investment incentive, share price and liquidity consequences outlined in Section 2.4 will arise. This appears to be a very large price to pay for avoiding what may be only a relatively small eventual externality cost. Furthermore, it appears inconsistent with the approach taken by governments in respect of other risks to the national economy¹³. Governments routinely assume residual risks that are uninsurable in the private sector in order to stimulate increases in overall national economic activity (e.g. earthquake insurance, and government guarantees for trading banks offered in the recent economic crisis). This occurs because governments are able to spread the cost of bearing the risk across all residents, rather than imposing the costs of risk management solely upon the existing asset owners.

To refuse to allow a transaction to proceed because of government risk aversion would appear to be justified only when the possible maximum loss from externalities is larger than even the government (as represented by the aggregate of its residents) could bear. In practical terms very few cross-border transactions would meet this threshold. Thus for most purposes, the test of expected private benefits exceeding expected external costs would appear to be sufficient to protect governments from the consequences of undiversifiable risks associated with transactions including land.

2.8 Profit Repatriation

A commonly voiced concern about overseas investment is that profits generated as a consequence are likely to be repatriated offshore (e.g. Cunliffe, 2010). However, this concern is not founded upon rational economic analysis, and therefore should not be considered as a ‘negative externality’ arising from the foreign investment. Under normal economic circumstances, future potential profit expectations are fully internalised into the purchase

¹³ The optimal allocation of risk depends on the type of risk. Controllable risks are best borne by the party who can take action to reduce the risk to an efficient level. Truly random risks are best borne collectively, and where the whole of society is affected government is the appropriate institution to bear the risk (Milgrom & Roberts, 1992).

price accepted by the local asset vendor. The local resident will sell the asset only if the price paid reflects a greater return on the capital investment arises from sale than is on offer from continuing to own the asset – that is, the local owner has other, more highly-valued opportunities to apply the capital released by sale than is available from ongoing ownership. The net result of the sale is therefore increased local economic benefit, regardless of the nationality of the purchaser. Repatriated profits (taken as dividends or a capital gain following sale of the asset) are simply the reward that incentivises capital purchase and enhancement by a foreign owner whose specific characteristics enable more efficient use of (greater productivity from) that asset than the local owner. Without profit as an incentive, there will be reduced competition in product and ownership markets and substantially less innovation.

2.9 Should firms with market power be treated differently?

Some commentators have suggested that sovereign governments may take a different view of foreign investment in firms that are able to exert significant market power in the local economy from that in firms transacting in more competitive markets (e.g. Shearer & Thirlwell, 2008). The owners of firms with market power are in a position to charge prices in excess of costs. These *monopoly rents* remain in the local economy when the firm's owners are local residents, but will leave the local economy when the firm is purchased by foreign investors¹⁴. It may be argued that foreign ownership of firms with market power thus leads to an unequivocal cost to the local economy, so transactions leading to such an outcome should be prevented.

However, a cost-benefit assessment (CBA) of the proposed transaction should take account of both the costs and benefits arising. A rational local owner will consider the future earning potential of the assets when setting the price at which he is willing to sell. He will not sell unless the price received compensates him for the foregone monopoly rents. Thus not only do the rents not leave the local economy, they are also capitalised with certainty immediately, rather than being realised over time and therefore becoming subject to currently unforeseeable uncertainties that could impair their magnitude (such as innovation, increased competition or potential future regulation). This implies that firms with market power should not be treated

¹⁴ A related issue arises with the ownership of un-moveable assets that enable lower-cost production. Don Argus, the chairman of BHP Billiton, describes such assets (e.g. mineral resources) as 'endowment assets' and argues that the rents from such assets should be retained in the local economy (Stevens, 2009). Arguably this is a resource-pricing issue rather than a foreign investment issue. Governments, as owners of the endowment assets, should set royalty rates so as to capture the rents from endowment assets directly rather than preferring to gift those rents to a local firm.

differently to firms without such power by a foreign investment screening process¹⁵. Only if there are other externalities pertaining to the transaction that result in the social costs outweighing social gains¹⁶ should intervention be indicated.

2.10 Should investments by foreign governments be treated differently?

Over the past 15 years there has been a substantial rise in the amount of foreign investment activity by foreign governments via Sovereign Wealth Funds (SWFs) or state-owned enterprises (SOEs) (Hansen, 2008; Mogg, 2008). Concerns that investors with links to foreign governments may not operate solely in accordance with normal commercial considerations and may instead pursue broader political or strategic objectives prompted the Australian Government in 2008 to adopt tougher rules for the screening of such investments than for comparable investments from commercial entities¹⁷.

There are also concerns about the accounting transparency of such organisations. Poor transparency may create conditions under which it is more difficult to detect transfer pricing or other tactics to reduce tax payable in the host country. This issue could be effectively addressed using a screening test on the identity of a foreign investor; however any such test for accounting transparency should logically be applied to all investors rather than specifically to SWFs or foreign SOEs.

2.11 Non-economic reasons for intervention

Economic analysis suggests that, in general, the appropriate policy towards overseas investment is neutrality, neither favouring nor discriminating against foreign investors (Golub, 2003). Nonetheless a wide variety of concerns persist about loss of national sovereignty, perceptions of ‘excessive’ foreign control over those assets and adverse effects on national security. Such concerns have led many OECD countries to impose specific restrictions on foreign ownership in those sectors considered to be most sensitive, typically defence, telecommunications, air and sea transport, finance and the media.

¹⁵ The Commerce Act 1986 should mute the excessive use of market power by firms operating in New Zealand. An Overseas Investment Act should concern itself only with potential behaviour that will not be caught by the Commerce Act.

¹⁶ For example, if the foreign purchaser has market power in respect of the investment transaction itself (e.g. a monopsony purchaser who can set the sale transaction price so that it is not truly a ‘freely negotiated’ trade) then there will be no local vendor gain from the sale, and the rents will exit the local economy. However, under a well-functioning overseas investment process, the economic assessment of the sale should detect the net cost to the local economy and invoke steps for preventing the transaction proceeding.

¹⁷ <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&DocType=0>. Accessed 2 June 2010.

Non-economic concerns relating to specific sensitive sectors are best dealt with via targeted mechanisms rather than a broad investment screening mechanism. In particular, it may be that the investment transaction is not the most appropriate point of intervention to achieve the desired goal. For example, the Australian Airports Act 1996 places a series of restrictions on the ownership of airports:

- a 49% limit on foreign ownership;
- a 5% limit on airline ownership;
- a 15% limit on cross-ownership for Sydney/Melbourne, Sydney/Brisbane and Sydney/Perth airports;
- the central management and control of an airport-operator must be exercised at a place in Australia; and
- A majority of directors of an airport-operator company must be Australian citizens and/or residents¹⁸.

These firm-specific restrictions are in the forms of outcomes, which could not be effectively achieved via a foreign investment screening mechanism.

If there are to be restrictions on the freedom to trade interests in specific firms, then such restrictions should be explicit and transparent *before* any transactions are contemplated. With clarity and transparency around these restrictions, the likelihood that negotiations for exchange will begin in good faith based upon the economic consequences of the transaction, but then become subject to uncertainties surrounding the likelihood of approval being denied on the basis of subsequent non-economic considerations overriding the economic ones is much lower.

2.12 Political economy considerations

It is noted, however, that as a consequence of the political processes that determine the appointment of those overseeing and executing government powers, there could be direct personal political risks to the appointed decision-making agents arising from specific decisions that are not easily diversifiable. This leads to a conflict between the decision-makers as agents of their political principals and their role as custodians and stewards (agents) of the national economy (where the principal is the collective national citizenry) (Buchanan, 1994; Horn, 1995). When such conflicts arise, the decision-makers will most likely prioritise the agency that provides them with the greatest personal return (Holmstrom & Milgrom, 1991).

¹⁸ See https://secure.dotars.gov.au/webforms/infopages/Ownership_control_airports_overview.htm and <http://www.treasury.govt.nz/publications/informationreleases/overseasinvestment/pdfs/t2008-297.pdf>. Accessed 2 June 2010.

Thus, it is plausible that some intervention decisions may ultimately reflect short term political interests rather than long-term economic considerations. Those decisions associated with land-based assets may be more likely to invoke such attention, simply because of the inability to diversify away the political consequences of electorally unpopular, but economically rational choices.

2.13 Summary

A principled overseas investment screening mechanism should be focused upon maximising the economic efficiency of the local economy. To further this objective, such an Act should grant the sovereign government the ability to examine transactions between its residents and foreign parties, or between foreign owners of local assets. If, upon examination, it is assessed that there is an expected net negative consequence upon the territorial economy if the transaction proceeds, then a legitimate power may be granted to the government to prevent the transaction from proceeding.

There are costs to the local economy of such a mechanism, even if well-designed and efficiently implemented. It is therefore prudent to exclude from consideration all transactions (or classes of transactions) where the risks of negative outcomes are small or easily diversifiable.

This Section has presented a framework of factors to consider in the design and operation of an optimal overseas investment screening mechanism aimed at increasing the economic potential of a country. The key characteristics of the framework are summarised in Table 1. Sections 3 and 4 examine the New Zealand Overseas Investment Act and contrast it with this framework.

Table 1. Summary of conceptual framework for an overseas investment screening mechanism

Criteria	Conceptual model
External costs and benefits examined	All that accrue in within local territory or to local citizens
Private costs and benefits examined	All that accrue in within local territory or to local citizens
Weighting of factors	Equal weighting in monetary terms
Treatment of uncertainty	Incorporated into cost-benefit assessment based on probability of occurrence
Decision criteria	Net benefits neutral or positive
Decision criteria: transactions between foreign parties	Suitability of new investors
Counterfactual	Refusal of application
Non-economic criteria	Achieved via other mechanisms
Transparency of process	High
Clarity of criteria	High
Predictability of outcome	High
Transaction costs for applicants	As low as feasible
Treatment of transactions where the risks are small or easily diversifiable	Not screened
Suitability of foreign investors	Applicants meet equivalent criteria to what would be required of a local owner, including accounting transparency

3. The Overseas Investment Act 2005

The New Zealand government's approach to the trading of assets between New Zealand citizens and foreign investors can be assessed using the framework developed in the preceding Section. The governing legislation is the Overseas Investment Act 2005. Its processes are administered by the Overseas Investment Office (OIO)¹⁹, a division of the government department Land Information New Zealand²⁰. The Act has a strong focus on the ownership of land, which is best understood in light of the history of the Act (see Box 3).

When the OIA was reviewed in 2003, the government stated that it “was committed to maintaining a liberal investment regime because New Zealand needed foreign capital if it was to return to the top half of the OECD and to develop the economy to its fullest potential”.²¹ This suggests that the government's intention was to encourage growth of the local economy. From Section 2 it might be expected that its citizens are supported in the free trade of land and corporate assets with foreign entities, except in the limited circumstances where it is assessed that there is a net cost to the New Zealand economy. Assessments would be expected to balance the social gains accruing to New Zealanders against social costs, with certain gains accruing being weighted more highly than uncertain losses.

The government's clearly-articulated objective has not been translated into the purpose and principles of the relevant Act. The stated purpose of the OIA is “to acknowledge that it is a privilege for overseas persons to own or control sensitive New Zealand assets”²². Consequently the thresholds for government intervention focus strongly upon the nature of the assets subject to transactions between New Zealanders and foreign investors, and the definition of what constitutes a ‘foreign ownership interest’ in an asset rather than upon economic objectives. The statutory processes for assessing transactions of interest therefore subjugate economic consequences of the transaction to considerations of the assets in question and the identity of the foreign investors.

¹⁹ <http://www.lin.govt.nz/overseas-investment/index.aspx>. Accessed 2 June 2010.

²⁰ <http://www.lin.govt.nz/about-linz/index.aspx>. Accessed 2 June 2010.

²¹ <http://www.beehive.govt.nz/release/1st+principles+review+overseas+investment+act>. Accessed 2 June 2010.

²² S.3

Box 3. A short history of the Overseas Investment Act 2005

Legislation to control land ownership – in particular the ownership of farm land – has a long pedigree in New Zealand. While policy from 1840-1853 was directed at restricting the disposal of Crown Land, this changed in the 1850s to the promotion of land settlement and by the mid-1860s leases were taken up for all available pastoral land. However, inconsistent application by some provincial governments and blatant political favouritism by others resulted in large tracts in some provinces coming under the control of a small number of run holders (notably the South Island high country, Marlborough, Nelson and Hawkes Bay – Boast, 2008; McIntyre, 2008). Consequently, the Land Act 1877 introduced a nationwide policy of auctioning land leases. Leaseholders were required to reside on the land and make improvements. The main aim of legislation from the 1880s was “closer settlement” – to assist small-scale farmers to settle on the land while discouraging the aggregation of land to an undesirable extent. Closer settlement was seen as a way of expanding production with an ideal social structure of family farm ownership (Fairweather, 1985).

The twin goals of closer settlement and discouragement of undue aggregation are also apparent in the Land Settlement and Promotion Act 1952. Intending purchasers of farm land were required to sign a declaration that they did not already own land, or in the case that they did, to seek clearance to purchase from the Land Valuation Tribunal. The Act also required that purchasers of farms land reside on and farm the land. That requirement was later lifted. A 1968 amendment introduced provisions to control acquisition of land by overseas corporations and persons who were not New Zealanders.

The Overseas Investment Act 1973 created an Overseas Investment Commission whose role was to “supervise and control” overseas investment in New Zealand. This Act was focused on investments in businesses and securities and the raising of debt, and was administered by the Reserve Bank of New Zealand. In 1995 the Land Settlement Promotion and Land Acquisition Act 1952 was repealed and its provisions relating to foreign purchase of land were consolidated into the Overseas Investment Act (Treacy, 1995).

The Overseas Investment Act 1973 was reviewed in 2003 and replaced by the Overseas Investment Act 2005. The 2005 Act is similar in intent and operation to the Act it replaced, however its administration was moved from the Reserve Bank to the newly created Overseas Investment Office located within Land Information New Zealand.

The OIA process requires approval to be sought in relation to acquisitions by overseas persons of 25% or more direct or indirect ownership and/or control of interests in:

- significant business assets (new businesses and shares in existing businesses with assets in excess of \$100 million²³, or where the price paid for the shares exceeds \$100 million);
- sensitive land²⁴, defined as land purchase and any other interest (e.g. a lease) for a term of three years or more in:
 - (a) any foreshore, seabed, lake bed, regional park, land reserve, land held for conservation purposes or subject to a heritage order;
 - (b) any non-urban land in excess of 5 hectares;
 - (c) any land in excess of 0.2 hectares adjoining the foreshore;
 - (d) any land in excess of 0.4 hectares that adjoins a lake, reserve, heritage or conservation land (i.e. (a) above) or includes an historic place, area or wahi tapu²⁵; or
 - (e) any land on specific islands;
- farm land; and
- fishing quotas²⁶.

Under the OIA all decisions are made by the relevant government Ministers²⁷. However the Act provides for decision-making responsibility to be delegated to other persons (S.32). In practice it appears that decisions on the great majority of applications are made by the OIO.

Figure 2 shows a simplified flowchart of the assessment process. It can be seen that the key decision points in the process are driven by the area of land involved in the transaction, and the characteristics of that land.

²³ All dollar amounts in this paper are in New Zealand dollars unless otherwise indicated.

²⁴ This is a summary of the definition of “sensitive land” in Schedule 1 of the Act. It is very broad and it can be expected that the majority of productive businesses in New Zealand would have an interest in land that meets one or more of these criteria.

²⁵ *Wahi tapu* is defined in the Historic Places Act as *sites and places sacred to Maori people in the traditional, religious, ritual or mythological sense*.

²⁶ Consideration of fishing quotas is outside the scope of this paper.

²⁷ The relevant Minister or Ministers for each decision is determined according to S.24(1).

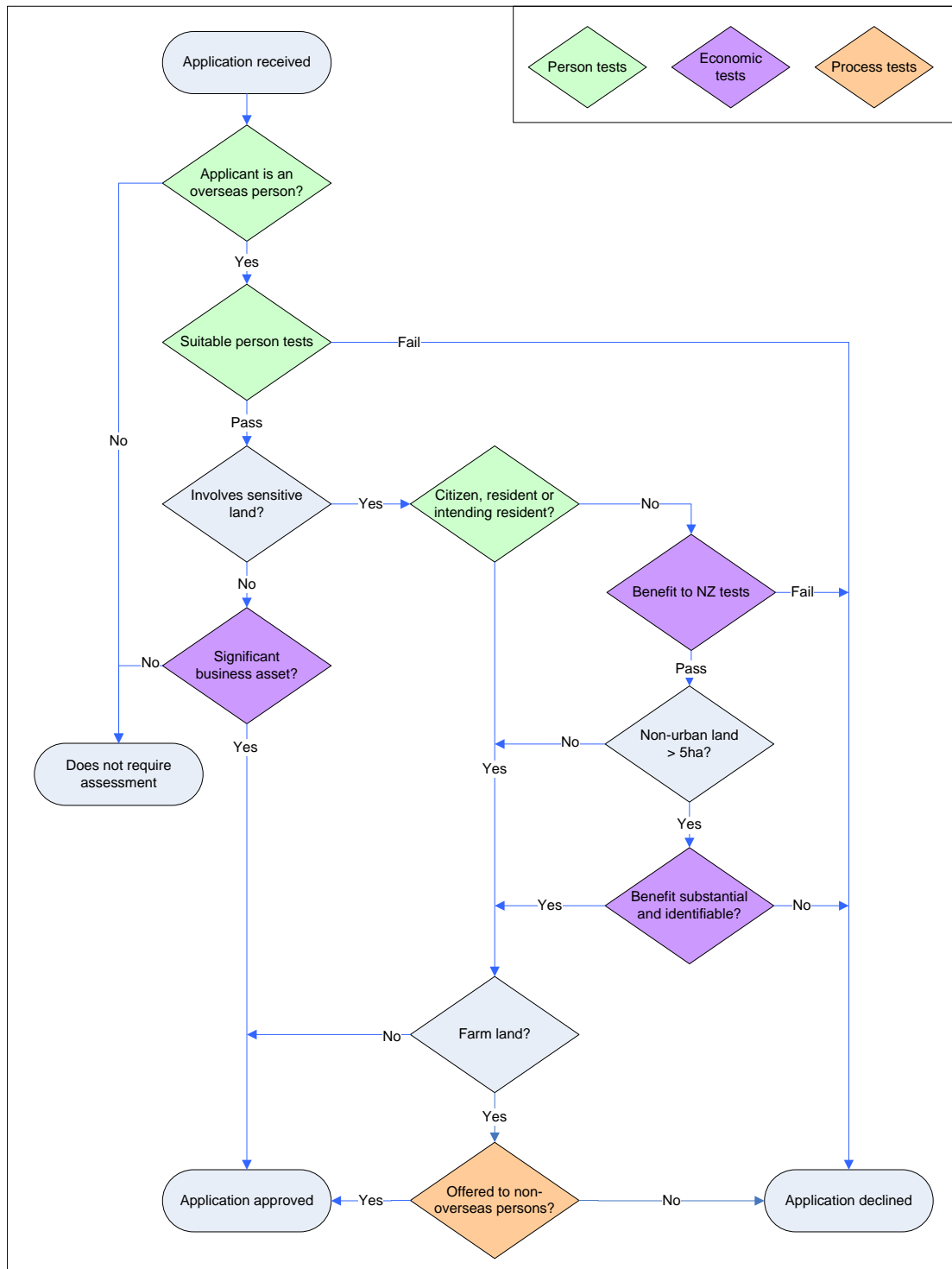


Figure 2. Simplified flowchart of the OIA assessment process.

The provisions in the OIA specifying how applications are assessed can be translated (see Appendix 1) into six types of test that are required to be performed (see Table 2). Broadly, the six test types can be categorised as assessing investor identity (test type 1), economic implications (test types 2 to 5) and process (test type 6).

Table 2. Classification of tests under the OIA

No.	Test type	Applies
1	Character of the foreign investor	To all applications
2	The absence of (specific) negative externalities arising from the transaction	To applications involving sensitive land
3	The presence of (specific) positive benefits arising from the transaction	To applications involving sensitive land
4	The absence of (specific) negative foreign trade externalities or breach of international agreements in the case of refusal of the application	To applications involving sensitive land
5	Whether identified benefits are substantial and identifiable	To applications involving sensitive land and include >5ha of non-urban land
6	Whether procedures in the Act have been followed to ensure that specific types of land have been offered to potential local purchasers in addition to the ultimate foreign purchaser	To applications involving farm land and/or “special land” (foreshore, seabed, riverbed, or lakebed)

Tests for the character of the foreign investor presumably reduce the possibility of future negative externalities arising as a consequence of factors associated with the specific foreign individuals concerned (e.g. to screen out prospective foreign purchasers with undesirable characteristics such as past fraud convictions, multiple bankruptcies, etc). Similar tests are used, for example, to restrict who is permitted to become a citizen of, or a company director in, New Zealand. Hence the test is prudent if it precludes the possibility of any foreign individual who would not meet the standards applied to those New Zealanders owning and controlling the New Zealand assets assuming ownership and control of them.

The general process tests (type 6) grant New Zealanders a ‘right of refusal’ to purchase some land assets that might otherwise be sold to foreigners. S.16(1)(f) requires that, unless exempted under the Act, farm land must be offered for acquisition on the open market to potential local purchasers, however the vendor is not bound to accept a competing local offer. By requiring that farm land which might otherwise be sold to a foreigner be offered first to New Zealanders excludes the possibility that a private deal is sealed with a foreigner because an equal- or higher-valuing New Zealander simply did not know that the property was for sale. Whilst such a provision enables an equal or higher-valuing New Zealander to make an offer (thereby ensuring both the consumer and vendor surplus remain in the New Zealand

economy), it presumes that the vendor was not motivated to seek out the highest-valuing individual regardless of nationality in the first place (i.e. simply accepted the foreigner's offer as it exceeded the vendor's valuation). Furthermore, the statutory minimum of 20 working days²⁸ to notify potential New Zealand purchasers imposes a further disincentive for foreign purchasers as it increases the uncertainty that their offer will be accepted.

Moreover, a special type 6 test grants the Crown an exclusive option to purchase "special land" – foreshore, seabed or the bed of a river or lake – at a price to be determined by a public valuer²⁹. This option is best understood in terms of the political sensitivity and controversy surrounding potential Maori claims over these types of land.

If the benefits addressed in test type 3 apply to both private and external benefits, and the application of the economic tests (types 2 to 5) address the relative weighting given to certain and uncertain benefits, then on first evaluation the assessment process appear to conform to the general conceptual requirements of the framework developed in Section 2 above. However, closer examination of the OIA and its application confirms the presence of inconsistencies that may lead to less than optimal intervention decisions occurring.

3.1 Different tests for land and business transactions

The focus of the New Zealand Act upon the nature of the asset being transacted results in a substantially different examination process being undertaken depending upon whether or not any sensitive land is involved. If no sensitive land is involved, then only tests of type 1 (character of the applicant) are applied. Economic tests (type 2 to 5) are applied only to sensitive land transactions and business transactions where sensitive land is involved, even if the land concerned is peripheral to the business assets being acquired. Table 3 shows that in 2008, the vast majority (83%) of applications assessed by the OIO relate to transactions involving land.

The distinction between land and business transactions is consistent with the Section 2 hypothesis that governments may take a closer interest in transactions involving land. However, the absence of any economic tests in the case of foreign investment where sensitive land is not involved allows the possibility of costly negative externalities impacting upon the New Zealand economy from such transactions. In practice, the proportion of applications pertaining to significant business assets alone in 2008 was small compared to all other

²⁸ R.9(1)(a)

²⁹ S.17(2)(f) and R.12-25.

applications (17% - Table 3). None were refused. Whilst the proportion of applications is small, as transactions relating to business assets are of very high value (generally with a foreign component in excess of \$25 million), the economic cost of even a single transaction being wrongly approved may be large. Nonetheless, the very liberal approach to business transactions may simply be the cost of a policy commitment to free trade. If over a number of transactions, on average the benefits exceed the losses, the government may find it acceptable to bear this risk.

Table 3. Summary of 2008 decisions under the Overseas Investment Act 2005³⁰.

Test	Approved	Declined
Sensitive land	90	1
Significant business asset	22	0
Significant business asset on sensitive land	18	3 ³¹
Fishing quota	0	0
<i>Total</i>	130	4

With respect to foreign investment in the equity of a New Zealand company, the OIA test for a significant business asset applies if the value of the assets of that company (and the assets of companies in which it holds a 25% interest) exceeds \$100m. Using a minimum market capitalisation of \$100m as a conservative proxy³² for that test, at least 40% of New Zealand's listed companies are "significant business assets" under the Act. Collectively those companies represent 95% of the market capitalisation of the New Zealand Stock Exchange³³.

Many foreign equity investment transactions will fall below the thresholds for significant business assets, thereby ensuring that the substantial transaction costs of the screening process are imposed only in respect of those transactions deemed to be materially significant. However, if sensitive land is involved, then the business purchase transaction is subject to an OIA assessment regardless of the value of the assets concerned.

³⁰ Compiled from data at <http://www.lin.govt.nz/overseas-investment/decisions/index.aspx>. Accessed 2 June 2010.

³¹ Two of these three declined applications relate to the single proposed investment by CPPIB in Auckland International Airport. The third was New Zealand Steel Mining. These cases are considered in Section 4.

³² Due to the way the S.13(a)(ii) is worded, a company whose market capitalisation is lower than \$100m but holds a 25% or larger equity or control stake in subsidiaries could be considered a "significant business asset". For example, OIA approval was granted on 26 June 2008 for a \$15.4m purchase of equities in a company with an implied market value of only \$35m.

³³ Calculated using NZX data from 28 September 2009. Index securities, dual-listed and NZAX companies were excluded.

By way of example, applications considered under the OIA during 2008 included retirement villages, wineries and property development businesses where the business asset value was well below \$100m. These transactions were required to demonstrate strictly positive net benefits to the New Zealand economy, whereas a non-land transaction of a business valued at many multiples of these businesses would be subject to no economic test at all. It is questionable whether the current regime is applying scarce investigative resources to the transactions that pose the greatest economic risk.

3.2 The strictly positive benefits test

S.16(1)(e)(ii) requires that the benefits associated with the transaction be *strictly positive*. That is, where sensitive land is involved, the prospective foreign owner must demonstrate not just that the status quo will prevail as a consequence of the change in shareholding, but that the transaction will bring positive benefits to the New Zealand economy. A sensitive-land application that is assessed to have a neutral impact upon the New Zealand economy must be declined. For example, an existing foreign owner of sensitive land cannot sell that land to another foreign owner unless the new owner brings additional benefits to the New Zealand economy that the existing owner has not already brought. Owners of the land concerned (regardless of their nationality) now bear the risk that a prospective foreign purchaser may not be able to demonstrate the presence of such benefits, even when there is no evidence of a cost to New Zealand arising from the change of ownership.

The positive benefit test results in a very different allocation of the risks associated with business asset ownership depending upon the presence or absence of land. In the non-land business case, the government assumes all risks (both positive and negative) to the New Zealand economy arising from any sale to a foreign owner. The positive benefit test applied to sensitive-land transactions requires that the (private) vendor must personally bear costs from the down-side risks to the New Zealand economy as a consequence of the proposed transaction being declined. These are manifested in the lower price that will be (necessarily) paid for the business if sold to a New Zealand owner (i.e. the net private gain from the sale to the foreign tenderer has been foregone)³⁴. The positive benefit requirement thus reduces the growth potential of the New Zealand economy at the same time as it potentially ‘locks’ some businesses with land associated into perpetual New Zealand ownership, at the private cost of its New Zealand owners.

³⁴ The authors are aware of one case where a tender for a lifestyle block (sensitive land by virtue of adjoining a regional park) was awarded to a New Zealander offering 30% less than the highest (foreign) tenderer, due to the inconvenience and uncertainty associated with the ensuing OIA process.

The inconsistency creates an incentive for the reorganisation of business assets into separate firms in anticipation of sale to foreign interests in order to avoid the ‘positive benefit’ test (e.g. one firm managing the land-based assets which is retained in New Zealand ownership and another with the remaining business assets which is sold to foreign investors). However, where such reorganisation is not feasible, the outcome of a denied application is unequivocally a real cost to the New Zealand economy³⁵.

3.3 The substantially positive benefits test

S.16(1)(e)(iii) introduces a further, more rigorous net benefit test when more than five hectares of non-urban land is involved in the transaction. In this case the benefits identified must be “substantial and identifiable”. That is, not only must they be positive, but very much greater than zero. The costs and risks borne by owners of this type of land (or owners of firms with interests in such land) are therefore very much larger than those borne by owners of other types of land.

3.4 Some costs and benefits are excluded from consideration

In a standard CBA, all relevant costs and benefits of a proposal are calculated converted to monetary units, adjusted for risk and time and summed (New Zealand Treasury, 2005). If social benefits exceed social costs then the proposal should proceed, at least according to the Kaldor-Hicks criteria (see Section 2.2).

Overseas investments in sensitive land are required to meet the test that they will, or are likely to “benefit New Zealand (or any part of it or group of New Zealanders)” (S.16(1)(e)(ii)). A CBA, taking into account all material costs and benefits (including private costs and benefits) would be the standard economic approach to addressing the question. However the Act requires that the determination be made under S.17, in which the Ministers must consider 19 specific factors to determine which factors (or parts of them) are relevant to the overseas investment (S.17(1)(a)), and “must determine whether the criteria in section 16(1)(2)(ii) and (iii) are met after having regard to those relevant factors” (S.17(1)(b)).

An ambiguity is apparent here — it is unclear whether the list of 19 factors is exhaustive (as implied by S.17(1)(b)), or merely a checklist to ensure that specific factors considered

³⁵ Arguably, the provisions of a type 4 test requiring the absence of specific negative externalities when denying permission for a transaction to proceed might be invoked to avoid these consequences. However, the type 4 test in the New Zealand OIA is narrow in scope, and in practice will exclude consideration of private costs born by New Zealanders (See Section 3.7 below).

important by the legislators are not overlooked (as implied by S.17(1)(a)) while making a comprehensive determination as to whether a relevant benefit exists (S.16(1)(e)(ii))?

The ambiguity could be resolved by reference to S.14:

*“The relevant Minister or Ministers, in considering whether or not to grant consent to an overseas investment transaction,— (a) must have regard **only** to the criteria and **factors** that apply to the relevant category of overseas investment under this subpart (subject to this section)”* [emphasis added].

S.14 constrains decision makers to consideration of the factors specified in the Act and Regulations. Those factors are not comprehensive. For example the following would be excluded from consideration³⁶:

- Direct effects on indigenous fauna (as opposed to an effect on significant habitats of indigenous fauna).
- Changes in cycling, boating and other recreational access to the relevant land (as opposed to walking access).
- Almost all classes of costs incurred in New Zealand or by New Zealanders resulting from refusal of an application.
- Threats to New Zealand’s national security.

In summary, assessments made under the OIA are not a full CBA. This creates a risk of economically unsubstantiated decisions being made: the approval of applications with net costs or the refusal of applications with net benefits.

3.5 Inclusion of private benefits and costs

Having established that at least some relevant costs and benefits are excluded from consideration under the OIA, the key question is exactly what is included. In particular, none of the factors unambiguously addresses the assessment of private benefits and costs – a key requirement of the framework developed in Section 2. The only two factors that might be interpreted to include private gains are:

*“whether the overseas investment will, or is likely to, result in—
(iv) added market competition, greater efficiency or productivity, or enhanced domestic services in New Zealand; or*

³⁶ It is conceivable that some of these examples might be negated through the use of factor R.28(f) which allows the decision makers to consider whether an overseas investment might give effect to or advance a significant Government policy or strategy. If that is the case however, it would be difficult to argue that the operation of the Act was transparent or predictable.

*(v) the introduction into New Zealand of additional investment for development purposes*³⁷

It is clear that these factors are interpreted for the purpose of identifying a “benefit [to] New Zealand (or any part of it or group of New Zealanders)”, so that private benefits to a group of New Zealanders are explicitly included, as long as those benefits are of a type described by one or more of the factors.

As the terms “market competition”, “efficiency”, “productivity” and “development purpose” are not defined in the Act, and the Act concerns economic matters, it is reasonable to use the standard economic interpretation of those terms.

Three types of economic efficiency can be distinguished:

- *Productive efficiency* is achieved when goods are produced at the lowest cost of production.
- *Allocative efficiency* is achieved when resources are devoted to their optimal use. Its achievement requires, in general, buyers to face prices that reflect the marginal social cost of production, and no barriers to trade.
- *Dynamic efficiency* is achieved when optimal decisions are made on investment, innovation, entry and exit to create productive and allocative efficiency in later time periods³⁸.

Productive efficiency is very close to the concept of productivity³⁹. Because S.17(2)(a)(iv) explicitly lists both productivity and efficiency, it is reasonable to interpret efficiency in its wider sense, and not just as a synonym for productivity. Thus allocative and dynamic efficiency should be considered by decision makers when assessing this factor.

Dynamic efficiency may or may not be improved by a single overseas investment transaction. It may be difficult to forecast the dynamic efficiency consequences of a particular transaction at the time of assessment. But dynamic efficiency is promoted by the process of competition. Artificial barriers to investment, entry and exit (e.g. arising from inappropriate intervention to

³⁷ From S.17(2)(a).

³⁸ These definitions are drawn from the discussion in Economides (1999).

³⁹ Productivity can be defined as the ratio of outputs to inputs. Greater productivity is achieved when increased outputs can be produced for the same quantity of inputs, or alternately, the same outputs can be produced with a reduced quantity of inputs.

prevent a transaction between willing parties from occurring) will, in the general case, act to reduce dynamic efficiency.

As explained in Section 2.1, gains from trade arise when a transaction leads to a preferred allocation of resources between the buyer and vendor. Such gains can be viewed as a necessary consequence of an improvement in allocative efficiency. **Thus private gains from trade accruing in New Zealand and to New Zealanders directly satisfy the requirement for greater efficiency in factor S.17(2)(a)(iv).**

Private gains from trade accruing to New Zealanders will necessarily increase welfare in the local economy. The gains may be monetary or non-monetary⁴⁰. Monetary surpluses from trade may or may not be used directly as “investment for development purposes”, but they do nonetheless contribute to welfare in the local economy, and hence the potential for “investment for development purposes” to be undertaken. Whilst a commitment to use gains from trade for investment or development purposes could be made in support of a specific overseas investment application, there does not appear to be a general case that links local private gains from trade with factor S.17(2)(a)(v).

The inherent ambiguity in factor S.17(2)(a)(iv) and the narrowness of factor S.17(2)(a)(v) combine to create a situation where the private gains from trade could be overlooked by decision makers adhering strictly to narrow definitions of the decision criteria explicitly provided in the Act.

3.6 The weighting of costs and benefits is arbitrary

S.17(1)(c) allows Ministers discretion to “determine the relative importance to be given to each relevant factor (or part)”. This provision gives decision-makers complete flexibility to attach arbitrary weights to individual costs and benefits. It would be quite legal for decision makers to choose, for example, to double each cost and halve each benefit, or apply any arbitrary weightings in order to reach a preconceived determination.

While a full CBA could involve the calculation of monetary values for non-traded goods and services, and such calculations are by nature imprecise, accepted and defensible procedures do exist (e.g. Pearce, 1993; Augustyniak, 1993). Once the conversion to monetary units has

⁴⁰ In general, the consumer’s surplus (the amount he or she was willing to pay less the amount actually paid) on a transaction is non-monetary for a final consumer. This would be the case for a New Zealander purchasing a foreign good. The Overseas Investment Act is primarily concerned with New Zealanders as vendors selling to foreign purchasers, in which case the vendor’s surplus is monetary and the (non-monetary) purchaser’s surplus accrues overseas.

been undertaken, standard CBA requires that individual factors are not subject to arbitrary weighting⁴¹. The absence of clear guidelines as to how the weighting will be applied exposes transactions to considerable uncertainty. The Minister may choose to:

- a) weigh each factor in a single consideration; and/or
- b) apply different weights in different considerations.

This legislated ability to freely apply arbitrary factor weights creates a situation where there is no requirement for consistency within and between decisions under the OIA. The outcome of any one application is thus unpredictable, and the outcomes of prior applications offer minimal guidance for future applicants. S.17(1)(c) thus undermines the integrity of all assessments made under the OIA.

Without clear boundaries between acceptable and unacceptable overseas investments, more transactions will be subjected to scrutiny than is economically efficient. Changing Ministerial priorities will render the outcome of some applications matters of chance or political preference rather than decisions based upon economic principles. It would be surprising if such uncertainty did not have some effect upon the willingness of foreign investors to consider investing in New Zealand assets, especially if the OIA regimes in other jurisdictions provide greater clarity and hence certainty.

3.7 Which factual and counterfactual?

A CBA requires a clear reference point, either against alternative options or the status quo (New Zealand Treasury, 2005). Eighteen of the 19 factors include a phrase of the form “whether the overseas investment will, or is likely to...” – suggesting that the implicit reference point in the OIA is the status quo before the application was filed.

As discussed in Section 2.6, the mere act of receiving an offer from a foreign investor to purchase an asset changes the status quo. There are two possible outcomes of an OIA economic assessment decision – approval and refusal⁴² – and decision-makers should be tasked with contrasting these options and choosing the better of the two, even if the option chosen is worse than the status quo before an application was made, a return to which is extremely unlikely in the case of a refusal decision.

⁴¹ There may be a case for principled weighting in specific economic circumstances. See Evans (2004) for a discussion.

⁴² S.25 allows the relevant Ministers to grant consent to all or to parts of an application, and to attach whatever conditions to a consent that they think appropriate. If such a partial or conditional consent is under consideration, then it would be appropriate to include it in as an additional option in the cost-benefit assessment.

The remaining factor (R.28(c)) specifically allows for a consideration of the consequences of refusing an application, but only in respect of the considerations of adversely affecting New Zealand's image overseas or its trade or international relations (subsection i) or resulting in New Zealand breaching any of its international obligations (subsection ii). This very narrow set of criteria makes no allowance for any private costs or benefits, or local externalities, due to refusal.

These shortcomings in the Act could enable a high-cost refusal to be chosen over a low-cost approval.

3.8 Definition of an overseas person

The definition of an 'overseas person', combined with the acquisition threshold of 25% or more direct or indirect control of sensitive New Zealand assets appears to result in some apparently anomalous investigations. The 25% threshold means firms with ultimately quite small proportions of foreign ownership may be subject to testing, but it is feasible for significant foreign ownership to arise in some firms without a requirement for OIA approval.

The Act applies to a range of transactions involving 'overseas persons'. An 'overseas person' is defined (S.15) to be an overseas person making the investment (A), an associate of A in relation to making the investment, or in the case of a corporate entity, any individuals with a 25% or higher ownership or control interest in the overseas entity, members of the governing body of that entity or any other individual or body of individuals that the Minister might consider to have control of the overseas entity. The OIA process is invoked in respect of any purchase by an overseas person of only 25% of a relevant asset, and an 'overseas entity' need only have 25% foreign ownership to become subject to the process. Because the 25% threshold is applied cumulatively, inevitably the process requires examination of some transactions that will confer minimal overseas ownership and almost certainly no effective control.

By way of example, electricity supplier TrustPower was deemed a foreign entity in respect of the purchase by its wholly-owned subsidiary Follies Limited of 8.71 hectares of sensitive land in Marlborough, even though the ultimate beneficial ownership of the applicant firm was calculated to be 83% New Zealand⁴³. If TrustPower held a 25% ownership stake in another (otherwise locally owned) company B, then B would also be considered an overseas person,

⁴³ <http://www.lin.govt.nz/overseas-investment/decisions/decision-summaries/2008-03/d200810023.pdf>. Accessed 2 June 2010.

despite having almost 96% local ownership. B would be subject to exactly the same provisions of the OIA as a 100% foreign-owned foreign-domiciled company.

Conversely, the 25% threshold in respect of each transaction means that the Act may not capture dispersed trading that can ultimately result in significant foreign ownership. If a hypothetical New Zealand company C had five equal (20%) shares, then those equal shares could be freely traded amongst local and foreign investors, even if the firm was valued in total at more than \$100 million and regardless of the presence or absence an interest in sensitive land. Unless two or more of the foreign investors were deemed to be ‘associated’, it would not be necessary for the OIA to screen any sales of shares in C even if the net effect of a series of transactions was a change from 100% local to 100% foreign ownership⁴⁴, as each individual foreign interest falls below the 25% threshold.

The OIA makes no distinction between transactions that have the overall effect of increasing foreign ownership from those that do not change or actually reduce the overall level of foreign ownership. When combined with the strictly or substantially positive benefits test, this could lead to the requirement to demonstrate strictly or substantially positive benefits arising from a transaction that actually increases the share of New Zealand ownership. For example, a firm with 25% foreign ownership would require the permission of the OIO to purchase a firm D with 50% foreign ownership, even though the transaction would reduce D’s beneficial local ownership from 50% to 75%. Unless sufficient benefits were identified, a transaction which had the effect of increasing local ownership would be refused. This is a perverse consequence of an Act drafted with presumably the opposite intention.

3.9 Non-economic criteria

Table 2 classifies the statutory and regulatory tests undertaken on transactions involving sensitive land under three broad criteria: character, economic, and process. In undertaking this classification, it has been presumed that the primary objective of the Act is to prioritise the economic consequences of the transaction. Generally, this appears to be the primary consideration given the wording of the criteria. However, two of the factors for assessment contained in the Overseas Investment Regulations 2005 appear to leave open the possibility of non-economic considerations influencing a decision. These are R.28(f) “whether the overseas investment will, or is likely to, give effect to or advance a significant Government policy or

⁴⁴ Of course, once company C became 25% or more foreign owned then further local investments by it would be subject to the OIA.

strategy” and R.28(h) “whether the overseas investment will, or is likely to, assist New Zealand to maintain control of strategically sensitive infrastructure on sensitive land”.

Whilst it might be expected that a principled assessor would interpret these factors for their economic consequences, it may be that for political reasons the underlying policies or control intentions are inconsistent with the objective of enhancing national economic growth (such policies or intentions could be, for example, the nationalisation of specific industries or New Zealand citizen control of specific firms). The presence of these factors in the Regulations appears to be more consistent with an objective of limiting foreign control of sensitive New Zealand assets per se, than with providing appropriate incentives for both New Zealanders and foreign investors to invest and trade in a welfare-maximising manner.

It begs the question of whether it is appropriate to use an Overseas Investment Act which ought to be predicated upon economic objectives to achieve overtly non-economic purposes. If some assets are deemed so sensitive that it is inappropriate for non-New Zealanders to have ownership stakes beyond a certain level, then it may be more appropriate to reserve these ownership controls via other mechanisms (for example, specific legislation for particular properties or shareholder restrictions in company constitutions) rather than risk distorting the flows of international capital in all firms, for fear that the non-economic criteria may be brought to bear in an individual decision. Such provisions would also remove some degree of judgement required be exercised by officials in the OIO in respect of these non-economic criteria, given that there is no guidance given in the Act or Regulations as to what weight should be given to each individual factor.

3.10 Transparency, clarity and predictability

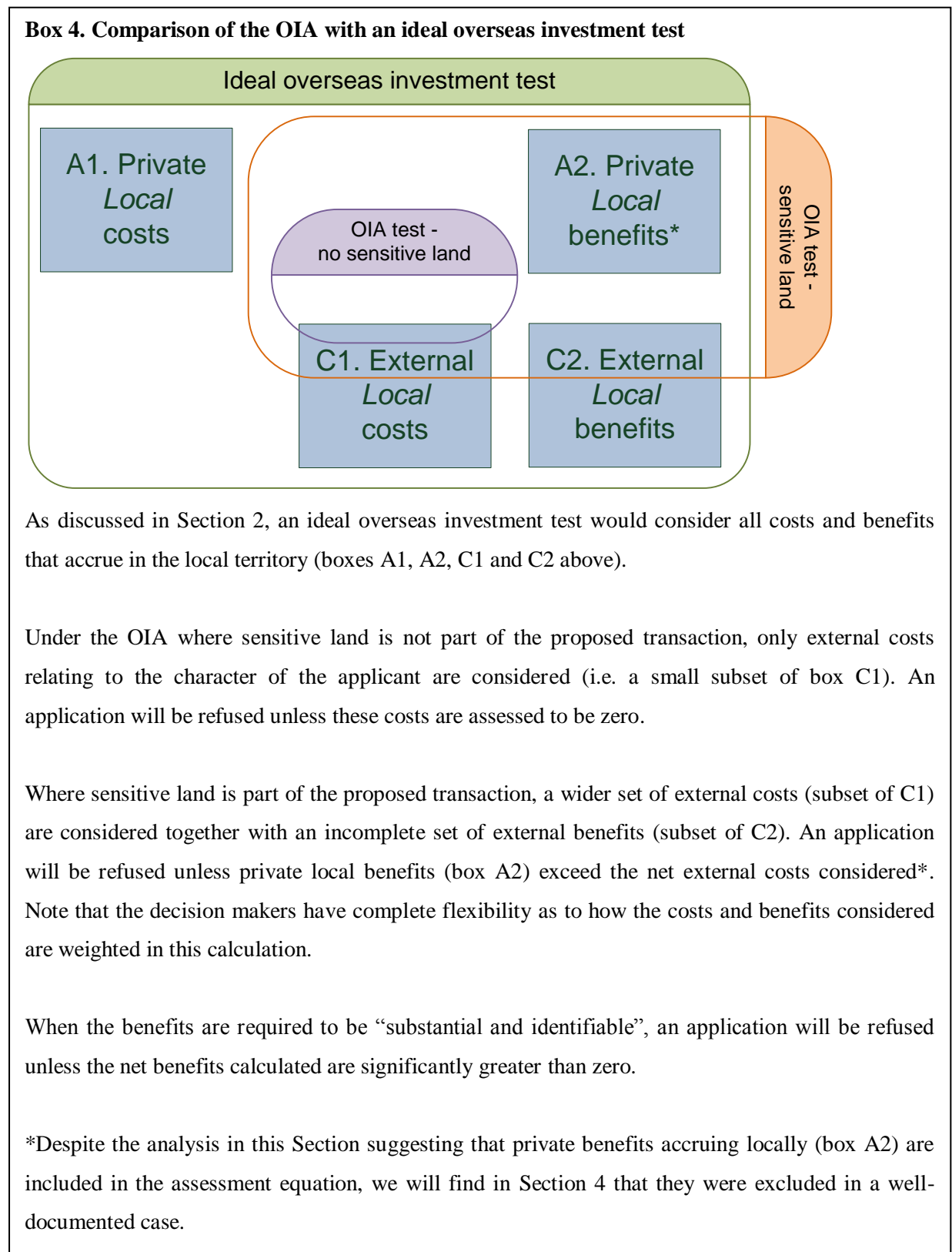
Issues that reduce the transparency, clarity and predictability of the OIA include the lack of definition of key terms (Section 3.5), flexibility in the selection and weighting of factors (Section 3.6) and lack of a clear counterfactual (Section 3.7). Decisions made under the OIA can only be challenged on procedural grounds, and consequently decision-makers cannot be held to account for their decisions (other than through the political process). Allowing decisions to be reviewed on their merits by the courts would, over time, standardise interpretation of the Act and permit the reversal of anomalous decisions, thus improving the predictability of its application.

3.11 Overseas investment screening in other countries

In Australia, the presumption is that foreign investment is generally in the national interest (The Treasury, 2009). The US regime focuses on national security. The UK places no limits of foreign investment. China limits both who can invest (“qualified foreign institutional investors”), the maximum amount they can invest (US\$1bn) and the aggregate total of foreign investments (US\$30bn) in its local share market⁴⁵. The New Zealand system is notable within these examples for its focus on land and its strictly positive and substantially positive benefits tests.

⁴⁵ <http://www.dailyfinance.com/2009/09/04/china-set-to-increase-foreign-investment-limits-to-1-billion/>. Accessed 2 June 2010.

3.12 Summary



Box 4 contains a comparison of the New Zealand OIA with the conceptual model developed in Section 2.

It would appear that the OIA is less stringent than the Section 2 conceptual framework in assessing applications which do not include sensitive land. In theory an application with substantially negative net benefits could be approved. It should be noted however, that a change of ownership by itself is unlikely to generate negative externalities, and that other legislation should act to directly ameliorate externalities⁴⁶. Conversely, the OIA appears substantially more stringent than the conceptual framework where sensitive land is involved, in particular with the requirement that the identified benefit is strictly positive (or substantially positive).

These observations beg the question of the fundamental purpose of the Act. Is it primarily focused on the identity of firm owners (foreign or New Zealand) and controlling the extent to which the 'privilege' of foreign ownership is granted in respect of specific New Zealand assets, or the economic consequences for the New Zealand economy of transactions involving foreign entities? From Section 2, the identity of investors should matter only inasmuch as it determines:

- where the private benefits of a transaction accrue (locally vs. overseas); and/or
- the likelihood and magnitude of externalities imposed locally.

If it can be assumed that private New Zealand owners will not willingly trade with foreign investors to the extent that there are private detriments to the New Zealand economy, it is principally in respect of the external costs to the New Zealand economy where caution needs to be applied. These costs may be genuine economic externalities (i.e. tangible additional and undiversifiable costs to the New Zealand in excess of the private benefits accrued) or non-economic consequences (e.g. a reduction in aggregate New Zealand control of sensitive assets below an acceptable threshold).

As it currently stands, the New Zealand OIA appears to confuse the accrual of the costs and benefits to the New Zealand economy arising from a given transaction with the national identity of the individual transactors and preconceived control objectives associated with the particular assets being transacted. Consequently, the New Zealand OIA is not well-aligned with the articulated government purpose of developing the New Zealand economy to its fullest potential. Rather, it appears that the Act defines a set of procedures to ensure that

⁴⁶ Arguably the government would be remiss if it imposed laxer standards on local owners than overseas owners. The local costs of pollution (for example) are independent of the ownership of the polluter.

approved foreign investors are made aware of the “privilege” they have been granted under the Act to participate in the ownership and control of sensitive New Zealand assets. For those transactions that are subject to the Act, economic considerations are largely secondary to issues of the identity of the investor and the sensitivity of the assets concerned.

4. Case Studies

To test the national economic implications of the processes of, and decisions made under, the New Zealand OIA, in this Section we examine in detail the three transactions declined by the OIO during 2008, and contrast them with one that was approved.

Whilst relatively few applications under the OIA are refused, the cases examined here highlight anomalies in the economic consideration of applications that have arisen as a consequence of shortcomings identified in Section 3.

4.1 Auckland International Airport

The proposed sale of shares in Auckland International Airport Limited (AIA) to the Canadian Pension Plan Investment Board (CPPIB) offers excellent insights into the guiding principles and practical application of the OIA, due to the substantial quantity of information released into the public domain following the high-profile rejection of the application. Whilst some elements of the transaction are atypical (notably, the political sensitivity of the transaction), this case provides sufficient information for an assessment to be made of the processes involved, and especially the treatment of the relevant costs and benefits considered and the flexibility granted to decision-makers to assign arbitrary weights to particular factors when making an assessment of the of economic consequences of the transaction that underpins the acceptance or refusal decision.

4.1.1 Chronology

On 7 November 2007 the CPPIB announced a partial takeover bid for 40% of AIA, a listed New Zealand firm both owning land deemed sensitive under S.12 the OIA and meeting the definition of a sensitive business asset (exceeding the \$100 million threshold) under S.13. The offer was made at a 37% premium over the price before takeover speculation started on 5 May⁴⁷. As an ‘overseas person’ who under the transaction would acquire 25% or more ownership or control interest in “sensitive” assets, the CPPIB applied under the OIA for permission to make the investment should the takeover proposal be accepted. On 13 March 2008 the offer closed. Sufficient votes and acceptances were received from existing shareholders to approve the takeover under the Takeovers Code⁴⁸. The OIA application was

⁴⁷ http://www.cppib.ca/files/PDF/AIALPartialTakeover_Dec14_2007.pdf. Accessed 2 June 2010.

⁴⁸ <http://www.aucklandairport.co.nz/Corporate/NewsAndMedia/AllMediaReleases/CPPIB-Update.aspx>. Accessed 2 June 2010.

considered by the OIO who recommended to the Ministers on 1 April that it be approved and the transaction go ahead⁴⁹.

Meanwhile, the Minister of Finance requested that the Treasury draft legislation to specifically prevent the transaction from proceeding. The Treasury responded on 29 February 2008, expressing strong reservations about the Minister's proposed legislative intervention on legal, commercial and economic grounds⁵⁰. Instead, the Treasury proposed that the legal problems associated with the legislative approach could be reduced (but not eliminated) using an alternative approach: changes to the Regulations under the OIA. On 3 March 2008 Cabinet approved a proposal from the Treasurer to amend those Regulations to "strengthen the scrutiny of proposals which may alter the ownership of strategic infrastructure assets such as Auckland Airport"⁵¹. A new factor 28(h) covering "strategic infrastructure on sensitive land" was added to the Regulations; making a total of 19 factors to be considered when assessing applications. On 10 March 2008 CPPIB announced that it would voluntarily restrict its voting rights to 24.9%⁵², in an apparent attempt to limit the applicability of R.28(h) to their application.

On 11 April 2008, despite the 1 April recommendation from the OIO that the transaction proceed, the relevant Ministers announced that the application had been declined⁵³.

4.1.2 Rationale for declining the application

The reasons for the decision were released along with the announcement. The Ministers were not satisfied that all the criteria in S.16 of the Act had been met (Cosgrove & Parker, 2008).

The proposed investment was required to meet all of the seven applicable criteria in S.16⁵⁴. The first four criteria relate to the character of the applicant (type 1 tests), and both the OIO and Ministers agreed that they had been met. An exemption had been sought by the applicant

⁴⁹ <http://www.linz.govt.nz/docs/miscellaneous/cpp-20080411.pdf>. Accessed 2 June 2010.

⁵⁰ <http://www.treasury.govt.nz/publications/informationreleases/overseasinvestment/pdfs/t2008-297.pdf>. Accessed 2 June 2010.

⁵¹ <http://www.treasury.govt.nz/publications/informationreleases/overseasinvestment/pdfs/cabmem-3mar08.pdf>. Accessed 2 June 2010.

⁵² http://www.cppib.ca/News_Room/News_Releases/nr_03100801.html. Accessed 2 June 2010.

⁵³ <http://www.beehive.govt.nz/release/ministers+release+decision+overseas+investment+proposal+auckland+international+airport>. Accessed 2 June 2010.

⁵⁴ The application also had to meet the four criteria in S.18, however these can be disregarded as they are identical to the first four criteria of S.16.

on the seventh criterion relating to ownership of a farm⁵⁵. While the OIO had recommended granting of this exemption, the Ministers declined to consider the issue having found that the application did not meet the fifth and sixth criteria. The fifth criterion (S.16(1)(e)(ii)) is the “benefit to New Zealand” (or any part of it or group of New Zealanders). In assessing the benefit to New Zealand criterion the Ministers are required to take into account the 19 factors listed in S.17(2) of the Act and in Regulation 28 (summarised in Appendix 1), though they may decide what weight to apply to each of those factors. The sixth criterion (S.16(1)(e)(iii)) applies when more than 5ha of non-urban land is involved and hinges on whether that benefit is, or is likely to be “substantial and identifiable” (the substantially positive benefits test).

The separate assessments undertaken by both the OIO and the Ministers of the nineteen factors are summarised in Appendix 2. In the context of the proposed CPPIB investment in AIA, all factors except for S.17(2)(a)(iv) are assessed by both the OIO and the Ministers to be either a positive benefit for New Zealand, or not have a negative effect. In respect of S.17(2)(a)(iv):

“whether the overseas investment will, or is likely to, result in added market competition, greater efficiency or productivity, or enhanced domestic services in New Zealand”

the OIO assessed the effect of the transaction as “unknown” whereas the Ministers were “not persuaded” that a positive benefit existed. Both the OIO and the Ministers assessed as “unknown” the effects in relation to S 17(2)(a)(v):

“whether the overseas investment will, or is likely to, result in the introduction into New Zealand of additional investment for development purposes”.

4.1.3 Analysis

From Section 3, the New Zealand OIA requires that foreign investment in NZ equities must necessarily provide a positive benefit to New Zealand (i.e. an external gain), or “to any part of it or group of New Zealanders” (i.e. a private gain). From Section 2, this should be a net benefit, taking into account both the private costs and benefits and the external effects.

Using these principles, the CPPIB application appears to satisfy the test of substantial net benefits to the New Zealand economy. Firstly, the private gains are substantial. Based upon the share price prior to the offer and the price offered by CPPIB, the expected realised private

⁵⁵ This criterion (S.16(1)(f)) requires that farm land be offered for sale in New Zealand before it can be purchased by an overseas investor. Presumably has the application succeeded on the other criteria, an exemption would have been granted as it would not make sense to separate ownership of the relevant farm land (used as a buffer zone and reserved for future airport development) from the airport.

gain to those AIA shareholders who opted to sell⁵⁶ is \$466m, of which \$331m would accrue to existing New Zealand shareholders⁵⁷. Furthermore, the existing New Zealand shareholders who decline to sell to CPPIB would accrue an unrealized capital gain as a consequence of the sale proceeding at the offered price.

Secondly, there are also positive external benefits. Foreign investment in a firm previously owned only by New Zealand shareholders increases competition in the market for control of those companies. The existence of such a “market for corporate control” is an important factor in ensuring the efficiency and productivity of companies (Manne, 1965). Furthermore, the potential for foreign ownership increases the potential competition not just for those equities, but more broadly for the New Zealand stock market (given that substantial New Zealand-owned funds would be freed up for potential reinvestment in other firms).

Surprisingly, however, in the analyses released, neither the OIO nor the Ministers appears to have recognised any of these private or external benefits. Indeed, in their assessment, the Ministers specifically exclude the injection of foreign capital into the New Zealand economy as a consequence of the transaction from consideration as a benefit to New Zealand, when they state:

“There is no legal authority for Ministers to consider funds coming into this country as a benefit in itself, independent of evidence that the incoming funds are related to the statutory criteria and factors.” (Cosgrove & Parker, 2008, p.6)

That is, the \$1.75bn purchase price paid (freeing up capital owned by New Zealand vendors for further investment in the already thin New Zealand capital markets⁵⁸) was not considered a benefit to the country as per S.16(1)(e)(ii). Furthermore, nor were the certain private gains accruing to New Zealanders from selling to a foreign investor at a substantial premium over the current New Zealand share market price able to enter into the consideration of benefits accruing to New Zealand or New Zealanders.

⁵⁶ We do not have the information to calculate the buyer’s surplus on this transaction, and recognise that it would accrue in Canada anyway. However if it had of been unreasonably large (and not specific to CPPIB), then a counter offer from another investor would have been expected.

⁵⁷ This calculation uses a takeover premium of 37%, and assumes that the relative proportions of New Zealand and overseas-held share holdings (excluding CPPIB) is unchanged by the takeover. Share ownership proportions obtained from: <http://www.linz.govt.nz/overseas-investment/decisions/decision-summaries/2008-04/D200810034.pdf>. Accessed 2 June 2010.

⁵⁸ See Evans (2009) for a description of the New Zealand equity market.

The Ministers' conclusion is somewhat surprising, given that both the private and external gains from the trade appear to be specifically addressed as relevant in factor S.17(2)(a)(iv) (see Section 3.5).

Moreover, the Ministers go on to say that:

“even if we were accept there was such a benefit, we consider the requirement ... that the benefit will be, or is likely to be, substantial and identifiable, would clearly not be met.” (Cosgrove & Parker, 2008, p.6)

Given that the estimated \$331 million gain that would have been acquired by the local selling shareholders had the sale proceeded is both identifiable and certain; this finding is even more surprising. In the OIO analysis, the private and external gains from the transaction as per S.17(2)(a)(iv) and (v) were considered “unknown” – their net benefit assessment appearing to hinge upon the presence of “substantial and identifiable” historic heritage and walking access benefits⁵⁹.

If the \$331 million private gain was considered in the OIO or Ministerial assessments, then it would be expected that evidence of costs greater than this magnitude would be provided in order to justify the application being declined. No such evidence is provided. The application was declined by the Ministers on the basis of their not being “persuaded” that benefits existed under S.17(2)(a)(iv). Had it been mandatory for the Ministers to consider the economic consequences of refusing the application (as discussed in Section 2.6), then the foregone gains to shareholders excluded from the original analysis might have entered into consideration. But as no such consideration is required under the provisions of the Act, the substantial costs of the refusal decision have been borne by private New Zealand shareholders.

Aside from the additional foreign capital entering the New Zealand economy and private wealth gains to individual New Zealanders, there still appear to be net private and external benefits arising from the transaction⁶⁰. The CPPIB offer related to the purchase 40% of equity with only 24.9% of voting control. Arguably, this term was a strategic attempt to circumvent the issue of the identity of the controller of the sensitive land as being a potential disbenefit of the transaction. Nonetheless, the proposal effectively increased the amount of control power per share of every non-CPPIB shareholder. To the extent that control is valued, this is a

⁵⁹ See Appendix 2.

⁶⁰ The substantial and identifiable historic heritage and walking access benefits found by the OIO were the basis of their recommendation to approve the transaction (Overseas Investment Office, 2008). We would argue that this was an inadequate basis on which to decide a \$1.75bn investment proposal.

positive externality from the transaction that would have been (mostly) realised by the New Zealand owners.

If the Ministers had recognised the private gains as relevant, but wished for other reasons to discount them, then they would still have had the opportunity to exclude them by applying a weighting of zero in their assessment. As an importance ranking of ‘high’ was assigned to the S.17(2)(a)(iv) factors by both the Ministers and the OIO, then it can only be concluded that the private gains were either consciously ignored or overlooked in both the ministerial and OIO assessments⁶¹. Furthermore, only an extremely narrow interpretation of the benefits accruing from foreign investment or an inappropriate counterfactual could result in a finding of “unknown” or insufficiently persuasive external benefits from the transaction.

If the principles adopted for assessing the private and external benefits of this transaction are indicative of other assessments, it would appear that a systematic bias exists in respect of foreign investment applications involving sensitive land. This bias is likely leading to some transactions with net economic benefit to New Zealand being turned down. We note that had there been no sensitive land associated with the CPPIB application, then even though it exceeded the threshold for “sensitive business assets”, no economic analysis whatsoever would have been undertaken. The transaction would have been approved solely upon the basis of the purchaser’s character.

4.1.4 Regulation 28(h): strategic infrastructure on sensitive land

Much of the commentary on the AIA/CCPIB decision has focused on regulation 28(h) and its late injection into the decision-making process⁶². Its inclusion was almost certainly motivated by political rather than economic factors. It is therefore surprising to find that ultimately, it was not necessary to invoke it to prevent the sale of AIA to CPPIB⁶³. The normal OIA assessment of the costs and benefits of the application (albeit applied as described above) was sufficient to prevent the sale.

Indeed, a plain language reading of the new regulation, and the nature of its inclusion into the Regulations at the time of the CPPIB application lead us to question the very purpose of the Act. R.28(h) requires an assessment of whether an overseas investment in sensitive land will,

⁶¹ The OIO’s assessment of the benefits under S.17(2)(a)(iv) and (v) was “unknown”. We can reasonably conclude that they also excluded gains from trade from their assessment.

⁶² See for example, Evans, Quigley & Counsel (2009), Simpson Grierson (2008a; 2008b), and Regulations Review Committee (2008).

⁶³ <http://www.beehive.govt.nz/release/strategic+asset+investment+test+never+used>. Accessed 2 June 2010.

or is likely to benefit New Zealand to the extent that the overseas investment will “assist New Zealand to maintain New Zealand control of strategically important infrastructure on sensitive land”. It is extremely difficult to envisage how any foreign equity investment in “strategic infrastructure on sensitive land” could ever “assist New Zealand to maintain New Zealand control of strategically important infrastructure on sensitive land” (Hansen, 2008). Absent clear definitions of ‘strategically important infrastructure’, there remains considerable uncertainty about the application of this regulation.

By effectively introducing a zero incremental control threshold into the OIA, the regulation has apparently removed all incentives for foreign investment in infrastructure that might be subject to this regulation, as it is unlikely that any purchaser would be willing to pay to obtain 25% or more ownership with zero control rights.

4.1.5 Summary

If New Zealand is committed to maintaining a liberal investment regime because New Zealand needs foreign capital in order to develop the economy to its fullest potential, then this case begs the question of whether the OIA is supporting that purpose. Whilst the Act may have been designed with the principal intention to stimulate the inflow of foreign capital, the AIA/CPPIB case suggests that in practice, it is being applied in a manner that excludes from consideration all private gains emanating from the transaction. Moreover, it is open to being used as a political tool to prevent specific transactions.

In principle, the provisions of the Act (save for R.28(f) and (h)), if interpreted using the economic principles of Section 2, enable the majority of genuine benefits and costs to be fairly assessed. Yet in practice, if the analysis of costs and benefits exhibited in the declined AIA/CPPIB transaction is typical, then it would appear that the New Zealand OIA is being interpreted overly strictly in the case of businesses involving sensitive land regardless of the economic consequences. Whilst it cannot be discounted that a different standard was adopted for this politically sensitive and high profile transaction, the signal sent by this particular ruling will have the same effect upon prospective New Zealand and foreign investors – the risks associated with investment in sensitive land and “strategically important infrastructure on sensitive land” are substantial enough to discourage such investment. The overall effect is likely to be negative for the New Zealand economy.

4.2 Vector Wellington Electricity Network

Shortly after the CPPIB application was declined, the OIO approved the 100% sale of the Vector Wellington Electricity Network Limited (WEN) to Cheung Kong Infrastructure (CKI), a Hong-Kong based Chinese infrastructure company, for \$748m⁶⁴. As no land owned by WEN was deemed sensitive under the statutory definition, the application was only subject to the less onerous tests applying to significant business assets (Simpson Grierson, 2008b). As Vector's business includes the provision of local electricity reticulation to all of the capital city's residences and businesses over a network comprised of 2500km of electric lines, and the definition of sensitive land in the OIA is extremely broad, it is somewhat surprising to find that this transaction escaped any scrutiny under the sensitive land tests of the OIA.

It is possible, given that it occurred subsequent to the CPPIB application, that the Vector transaction was "carefully structured" to avoid invoking the "sensitive land" test (Hansen, 2008)⁶⁵. As an electricity distribution network would appear to be highly likely to be considered "strategic infrastructure"⁶⁶, the rationale for such a strategic rearrangement of affairs appears quite plausible. That such restructuring could in theory be undertaken to eliminate sensitive land from consideration highlights the weakness of the New Zealand Act in precluding economic consideration of transactions where no sensitive land is involved. Whilst it may well have been the case that an appropriately conducted assessment may have come to the conclusion that the net benefits in the Vector case were positive, it would have been prudent to subject this transaction to the same level of analysis as the CPPIB application.

The potential for strategic restructuring that the Act enables is itself costly to the New Zealand economy, as it encourages scarce resources to be diverted away from productive activity in order to circumvent the OIA processes. In the absence of externally-imposed restrictions, firm boundaries will be set to minimize the sum of production costs and transaction costs (Williamson, 1981). Transaction costs become the more important consideration when assets are specific to particular transaction. In the case of an electricity network, it can be presumed that electricity network infrastructure and the land on which it resides are co-specialised assets. Transaction cost considerations favour common ownership of those assets; therefore it is reasonable to expect reduced efficiency and lower productivity

⁶⁴ See: <http://www.lin.govt.nz/overseas-investment/decisions/decision-summaries/2008-07/D200820007.pdf>. Accessed 2 June 2010.

⁶⁵ As the network has been foreign owned twice in the past ("China's power play", 2008), a perhaps more likely explanation is that the restructuring occurred some time ago in response to the then prevailing provisions of the OIA.

⁶⁶ Indeed, in many other countries, electricity networks are subject to specific foreign investment restrictions (Golub, 2003; Doove, Gabbitas, Nguyen-Hong & Owen, 2001).

from separated ownership introduced solely to avoid regulatory scrutiny. Given that “greater efficiency or productivity” is presented as a positive factor in S.17(2)(a)(iv), such an outcome is perverse. Clearly it is inconsistent with the pursuit of the greatest possible economic benefit from transactions involving foreign investment.

It is not known how much “careful structuring” is being undertaken in order to circumvent the OIA, nor is it possible to estimate its cost to the New Zealand economy. However, given the different standards applying to business assets with and without sensitive land associated, it would not be surprising to find a significant number of cases.

4.3 New Zealand Steel Mining

In August 2008 BlueScope Steel announced an agreement with CKI for the sale of its New Zealand iron sands mining and export operation, the Taharoa Iron Sands business, for \$250 million⁶⁷. The Taharoa Iron Sands mine is located 200km south of Auckland and is operated by New Zealand Steel Mining Limited (NZSM), a 100% subsidiary of Australian-owned firm BlueScope Steel. The iron sand mine meets the definition of “sensitive” land as it exceeds 0.2 hectares and adjoins the foreshore, and the value of the business clearly exceeds the \$100 million threshold for significant business assets. CKI had agreed to buy the Taharoa iron ore mine with the intention of making additional investment to increase its iron sands production, and had presumably included these intentions in its application under the OIA. However changes in global economic conditions meant that CKI came to the decision that plans to expand the business were no longer viable. It did however express its intention to proceed with the purchase of the existing operation at the price originally offered, subject to OIA approval.

In December 2008 the OIO declined the application⁶⁸. The application was deemed not to have met the “criteria of substantial and identifiable benefit which was relevant to the acquisition of [significant] business assets which included sensitive land”⁶⁹. As the purchase of WEN seven months previously by the same applicant had been approved, it can be presumed that the good character tests had been met and so were not a factor in this decision. The OIO statement made particular reference to the fact that the proposed expansion had been

⁶⁷ http://www.hutchison-whampoa.com/upload_docs/2008/08/Energy/2036/2036_eng.pdf. Accessed 2 June 2010.

⁶⁸ <http://www.linz.govt.nz/overseas-investment/decisions/decision-summaries/2008-12/C200820037.pdf>. Accessed 2 June 2010.

⁶⁹ <http://www.beehive.govt.nz/release/purchase+nz+steel+business+assets+declined>. Accessed 2 June 2010.

cancelled, and no reference to any other factors involved in the assessment. As with the AIA case, it appears that neither direct benefits of the sale or costs of refusal were considered.

That the CKI application was declined may not be unsurprising, given the apparently high thresholds required to be met under the “substantial and identifiable benefits” test as it appears to have been applied in the CPPIB case. However, the NZSM case is notable because the vendor was already 100% overseas-owned. A transfer from one (presumably suitable) overseas owner to another suitable owner was blocked simply because the decision-makers did not identify substantially positive benefits accruing to New Zealand as a consequence of the change in foreign ownership.

It is not immediately apparent how the purpose of the Act (“to acknowledge that it is a privilege for overseas persons to own or control sensitive New Zealand assets”) was furthered by this decision. If a full CBA including the economic consequences of refusing the application had been undertaken, it is likely to have concluded that the New Zealand economy would have been worse off with BlueScope Steel continuing to own a mine that it clearly had no desire to continue owning given it had found and agreed a price with a willing buyer in CKI. As CKI had made a credible commitment to invest for expansion in more favourable economic circumstances, the firm would presumably be more inclined than the current owner to invest if and when economic conditions improved. This was likely a far better long term outcome for the New Zealand economy than preventing the sale of an already foreign-owned asset to another (acceptable) foreign owner.

By declining the transfer of ownership from one foreign owner to another (a transaction with an apparently neutral effect upon the New Zealand economy), the net result is likely a net external cost, as incentives for foreign investors to invest in New Zealand assets were thereby reduced.

The decision signals to other prospective purchasers of assets on sensitive New Zealand land that even though their purchase may bring benefits sufficient to allow the initial sale to be approved, if circumstances change necessitating the future sale of the firm, it may be impossible to sell to the highest-valuing individual if that individual is also a foreigner. The first foreign owner is in effect locked in to either perpetual ownership or forced to sell at a much lower price to a New Zealander, even though a foreigner may be willing to pay a higher price for an ‘as is’ going concern. The CKI-NZSM decision precedent means the price the first foreign buyer will be prepared to offer to purchase a New Zealand asset will be discounted to reflect the additional risks involved as a consequence of unfavourable OIA

decisions occurring in the future. Moreover, anything that lowers the potential return for a future overseas owner also lowers the potential returns for current domestic owners, reducing their incentives to invest in and expand their businesses whenever foreign investors are possible future purchasers.

The requirement that every potential overseas owner of an asset must create external benefits over and above those achieved by the current owner creates a ratchet – and therefore a perverse incentive for the current owner not to maximize the potential of their business if it is likely that they will be selling it in the foreseeable future (Simpson Grierson, 2009).

4.3.1 Summary

No apparent economic or non-economic objective was achieved by the decision to refuse this sale. Indeed there appear to be substantial net costs to the New Zealand economy from its refusal. The decision must therefore be regarded as a perverse or unintended consequence of the OIA, and a failure of the relevant Ministers and officials to recognise that situation and create an effective remedy.

4.4 J.O. Adams & Son Limited Pension Fund

In 2008 J.O. Adams & Son Limited Pension Fund applied under the OIA to purchase 61.8ha of land near Taihape adjacent to their existing farm:

“The proposed land acquisition will bring together the existing farm comprising 159.4269 hectares that the Pension Fund already owns, reuniting land that, until 1981, was farmed as one economic unit. The Pension Fund intends to acquire the land using its cash reserves held in New Zealand. Upon acquisition, J.O. Adams & Sons Limited ... will lease the land from the Pension Fund and will continue the current farm policy of deer and fawn production, as well as sheep and cattle farming.”⁷⁰

This application was declined in October 2008. The reasoning offered by the OIA in their published decision summary is uninformative:

“The overseas investment transaction has not satisfied the criteria in section 16 of the Overseas Investment Act 2005”

The ruling gives no indication as to whether the application was declined on good character, economic or process grounds. As the Fund has been previously granted OIA approval for

⁷⁰ <http://www.lin.govt.nz/overseas-investment/decisions/decision-summaries/2008-10/C200710023.aspx>. Accessed 1 June 2010.

rural land purchases in April 2001⁷¹ and May 2002⁷², it is unlikely that the cause of the rejection was unsuitability of the applicant.

However an application for the purchase of the same land by the same purchaser was approved in February 2009 – less than four months later. As the same high-profile legal firm handled both applications it is unlikely that the first rejection was due to inexperience with the OIA leading to a poorly-argued application.

The decision summary for the successful application stated:

“The overseas investment transaction has satisfied the criteria in section 16 of the Overseas Investment Act 2005. The 'substantial and identifiable benefit to New Zealand' criteria were satisfied by particular reference to the following factors:

- *Overseas Investment [Act] 2005*
 - *17(2)(a)(i) – Creation/Retention of jobs*
 - *17(2)(a)(ii) – New technology or business skills*
 - *17(2)(a)(iii) – Increased export receipts*
 - *17(2)(a)(iv) – Added market competition/Productivity*
 - *17(2)(a)(v) – Additional investment for development purposes*
 - *17(2)(a)(vi) – Increased processing of primary products*
- *Overseas Investment Regulations 2005*
 - *28(a) – Consequential Benefits*
 - *28(e) – Previous investments*
 - *28(g) – Enhance the viability of other investments”*⁷³

There was a change of government in New Zealand following the general election on 8 November 2008. It is apparent that the incoming Ministers held different views on the OIA from their predecessors, so it is not inconceivable that the different decision may have resulted from different political directions. However we note that responsibility for this decision would have been delegated to the OIO under the Designation and Delegation Letter dated 12 December 2007⁷⁴, and this letter still in force in February 2009 when the second

⁷¹ http://canterbury.cyberplace.co.nz/community/CAFCA/cafca01/apr01.html#_Toc522294059. Accessed 1 June 2010.

⁷² http://canterbury.cyberplace.co.nz/community/CAFCA/cafca02/may02.html#_Toc29552893. Accessed 1 June 2010.

⁷³ <http://www.lin.govt.nz/overseas-investment/decisions/decision-summaries/2009-02/C200821660.aspx>. Accessed 1 June 2010.

⁷⁴ <http://www.lin.govt.nz/docs/overseas-investment/oio-publications-designation-delegation-letter.pdf>. Accessed 1 June 2010.

decision was made. Similarly the Ministerial Directive Letter of 31 October 2007⁷⁵ which guides the interpretation of the OIA had yet to be changed by the new government.

We are left to conclude that the second decision represents a substantial turnaround in assessment processes by the OIO on what could not have been significantly different underlying case facts. Four months after having found no substantial and identifiable benefit to New Zealand arose from the transaction, such a benefit was found with reference to no less than nine factors. Many of those nine factors were clearly applicable at the time of the first application. For example, previous investments, enhancing the viability of other investments (the adjacent farms), added market competition and creation/retention of jobs. Possible explanations for the turnaround include lobbying of politicians or officials by the applicant, internal policy changes in anticipation of revised government priorities or inconsistently applied assessment processes. While we have no information that supports any one or more of these explanations being the most plausible in this case, it is of considerable concern that such a very different view should be taken of the desirability of what externally appears to be an identical transaction.

A principled assessment based on clear criteria of two substantially identical applications should have lead to identical assessment outcomes. However, the lack of transparency in the official documentation released surrounding the decision makes it impossible to determine what was different about the second application from the first. As future potential applicants will be relying upon past outcomes in assessing the likelihood of their own potential application being approved before even considering whether to make an offer to purchase a New Zealand asset, such vagaries are unhelpful. Was the application materially different? Or is there substantial discretion being exercised within the OIO processes? In either case, the result is that the application process is quite uncertain and therefore outcomes are inherently unpredictable.

This case study has highlighted a lack of consistent application of the OIA. Low levels of transparency and predictability in the current assessment process is likely harmful to the objective of encouraging foreign investment in New Zealand assets.

⁷⁵ <http://www.lin.govt.nz/docs/overseas-investment/oio-publications-ministerial-directive-letter-20071031.pdf>. Accessed 1 June 2010.

5. Discussion

An Overseas Investment Act should enable the free trade of assets between individuals and corporate owners, with minimal intervention rights granted to sovereign governments only in respect of instances where there are externalities that impact negatively upon the economy in question. Under these circumstances, the interests of private transactors and sovereign governments will be aligned, and national economies will have the best possible chance to grow to their full potential.

New Zealand has a smaller equity market relative to the size of its economy than comparable countries (Evans, 2009). Unlike the majority of those countries, New Zealand's domestic equity market shrank relative to the economy over the period 1996-2007. Evans also found that New Zealand had the smallest average listed company size. Decisions which affect incentives to invest in New Zealand firms are vitally important for the economic future of the country.

From an analysis of the principles and application of the New Zealand Overseas Investment Act 2005, it would appear that there are significant inconsistencies between theory and legislation, and between legislation and practice, that are likely hampering the performance of the New Zealand economy. The differences between theory and the actual practice of the OIA are summarised in Table 4. These differences are substantial.

Table 4. An assessment of the actual operation of the OIA against the conceptual model.

Criteria	Conceptual model	Actual OIA
External costs and benefits examined	All that accrue in New Zealand or to New Zealanders	Specified subset
Private costs and benefits examined	All that accrue in New Zealand or to New Zealanders	Ignored
Weighting of factors	Equal weighting in monetary terms	Arbitrary weighting as determined by decision makers
Treatment of uncertainty	Incorporated into cost-benefit assessment based on distribution of risky elements	Arbitrary weighting as determined by decision makers
Decision criteria: without sensitive land involved	Net benefits neutral or positive	Character of investor
Decision criteria: with sensitive land involved	Net benefits neutral or positive	Net benefits positive or substantially positive
Decision criteria: transactions between foreign parties with sensitive land involved	Suitability of new investor	Net benefits positive or substantially positive
Decision criteria: transactions between foreign parties with no sensitive land involved	Suitability of new investor	Character of new investor
Counterfactual	Refusal of application	The status quo ⁷⁶
Non-economic criteria	Achieved via other mechanisms	Mixed in with economic criteria
Transparency of process	High	Medium
Clarity of criteria	High	Low
Predictability of outcome	High	Low
Transaction costs for applicants	As low as feasible	Medium
Treatment of transactions where the risks are small or easily diversifiable	Not screened	Those involving sensitive land are subjected to the full screening process
Suitability of foreign investors	Applicants meet equivalent criteria to what would be required of a local owner, including accounting transparency	Applicants meet higher criteria than required of a local owner, but no test for accounting transparency

⁷⁶ Consideration is also given to a very narrow set of consequences of refusal. See Section 3.7.

5.1 Does New Zealand need an OIA?

A reasonable question to pose at this juncture is whether New Zealand needs an OIA at all? The Treasury suggests that the Act is somewhat redundant:

“While Treasury would be comfortable with removing the screening regime altogether and relying on protections in other existing legislation, we recognise that foreign investment raises concerns for a number of New Zealanders and some form of screening may help to alleviate these concerns.” (The Treasury, 2009, p.2)

Our conceptual model suggests that there are potential benefits to an overseas investment screening mechanism that screens out investment proposals that have substantial net costs for the New Zealand economy, if the mechanism can work without imposing significant costs on, or completely deterring, other investment proposals. Where the potential net costs are low then it is better to avoid screening and accept that the economy will benefit in aggregate from the overseas investments, even if the consequences of a subset of applications are negative.

A second reasonable question would be: does it really matter that New Zealand’s overseas investment screening mechanism could turn out to be inefficient, ineffective or sub-optimal? After all, Forbes ranked New Zealand 5th in its 2009 “best countries for business” analysis⁷⁷. McCann (2009) notes that for advanced economies, the economic performance of countries seems only loosely related to the quality of their institutions, and that economic geography and agglomeration are much more powerful predictors of national economic performance. In the context of New Zealand, McCann sees the critical issue to be the ability to create urban agglomerations that are attractive locations for research and development and as locations for functional units of multi-national enterprises. But even if McCann’s arguments are accepted, and improved institutional arrangements will not of themselves engender improved economic performance, there remains a strong case for institutional evolution to improve performance where this can be done at reasonable cost, in order to ensure that the outcomes achieved – within constraints of economic geography – are the best possible.

5.2 Recommendations for change

Many of the problems with the Act could be overcome by the replacement of the existing criteria and factors with a requirement for a full cost-benefit analysis. A reasonable objection to this proposal is that such analyses are expensive. However, only in the most borderline of decisions is an accurate assessment required of each cost and benefit. In the majority of cases,

⁷⁷ http://www.forbes.com/lists/2009/6/bizcountries09-best-countries-for-business_New-Zealand_CHI010.html. Accessed 2 June 2010.

a conservative approximation of the largest benefit compared with a generous assessment of the likely costs (or a conservative approximation of the largest cost compared with a generous assessment of the likely benefits) will be sufficient to determine whether net benefits are positive (or negative).

Widening the scope of benefits considered in assessing foreign purchase proposals to include private gains to New Zealand vendors and allowing sales to proceed when the benefits to New Zealand are not negative will result in a better alignment of the incentives for both buyers and sellers to engage in welfare-enhancing trades and improved capital markets performance, whilst still precluding investment where this would clearly be deleterious to the national economic interest.

Screening is best focused on those specific sectors of the economy with the potential to create substantial negative externalities, and on large transactions where the risk is not so easily diversifiable. Limiting the application of the OIA to these cases would reduce transaction costs, increase predictability and release resources for a more thorough and principled evaluation of significant transactions.

Such changes, however, do not address the fundamental conflict between an overseas investment strategy seeking increased foreign investment for economic purposes, and the application of the Overseas Investment Act for the largely non-economic purpose of retaining New Zealand control of a very small subset of assets, such as “strategic infrastructure”. It may be more appropriate to separate out such assets for consideration of separate, explicit ownership controls, thereby enabling the purpose of the Overseas Investment Act to be more appropriately and explicitly directed towards national economic imperatives.

Further changes to the Act are also indicated to improve its transparency, clarity and predictability.

6. Conclusion

New Zealand's Overseas Investment Act permits the confiscation of private property rights in order to meet wider social and economic goals. Confiscation – or indeed its mere possibility – has the potential to create high costs, so it should be avoided where feasible alternatives exist. The processes surrounding confiscation should be of the highest quality, and transparent and predictable for participants and observers.

Our examination of the OIA and its application to specific cases shows that it is neither transparent nor predictable, and it creates substantial disincentives for both foreign and domestic investment.

The review of the Act is both relevant and timely. If New Zealand wants to maximize the net economic benefits of overseas investments then substantial changes to the Act are indicated. The conceptual model developed in Section 2 and summarised in Table 1 can be applied as a minimum checklist of the desirable characteristics of a revised Act.

Appendix 1. Classification of tests under the OIA

Section	Summary	Classification ⁷⁸	Test type (see Table 2)
S.16(1)(a) S.18(1)(a)	Relevant business experience and acumen	Risk reduction (investor test)	1
S.16(1)(b) S.18(1)(b)	Financial commitment	Risk reduction (investor test)	1
S.16(1)(c) S.18(1)(c)	Good character	Risk reduction (investor test)	1
S.16(1)(d) S.18(1)(d)	Security or crime risk	Risk reduction (investor test)	1
S.16(e)(i)	Citizen, resident or intending to become a resident	Risk reduction	1
S.16(e)(ii)	Benefit to New Zealand (or any part or group of New Zealanders)	Requirement for strictly positive benefits	2/3/4
S.16(e)(iii)	Benefits are substantial and identifiable	Requirement for substantially positive benefits	5
S.16(1)(f)	Farm land offered to local purchasers	Process provides a mechanism to avoid negative externalities	6
S.17(2)(a)(i)	Creation or retention of jobs	Direct benefit or positive externality	3
S.17(2)(a)(ii)	New technology or business skills	Direct benefit or positive externality	3
S.17(2)(a)(iii)	Increased export receipts	Direct benefit or positive externality	3
S.17(2)(a)(iv)	Added market competition, greater efficiency or productivity	Direct benefit or positive externality	3
S.17(2)(a)(v)	Introduction of additional investment	Positive externality	3
S.17(2)(a)(vi)	Increased processing of primary products	Direct benefit or positive externality	3
S.17(2)(b)	Indigenous fauna	Absence of negative externality	2
S.17(2)(c)	Fish and game	Absence of negative externality	2
S.17(2)(d)	Historic heritage	Absence of negative externality	2
S.17(2)(e)	Walking access	Absence of negative externality	2
S.17(2)(f)	Foreshore, seabed, riverbed and lakebed offered to Crown	Process provides a mechanism to avoid negative externalities	6

(Continued on following page)

⁷⁸ This is an economic classification of the presumed intent of the relevant test. In the case of an overseas purchase of equity of a New Zealand business in which no additional investment or operational changes were planned, few of the direct benefits in S.17(2) are likely to be achieved.

(Continued from previous page)

Regulation	Summary	Classification	Test type (see Table 2)
R.28(a)	Consequential benefits	Positive externality	3
R.28(b)	Investor a key person in key industry abroad	Risk reduction/positive externality	3
R.28(c)	Trade and international relations	Absence of negative externality (from the denial of the application)	4
R.28(d)	Further significant investment	Positive externality	3
R.28(e)	Prior investments	Risk reduction/absence of negative externality (from the denial of the application)	4
R.28(f)	Advancement of government policies or strategies	Positive externality	3
R.28(g)	Enhancement of other overseas investments	Positive externality	3
R.28(h)	Assist NZ to maintain NZ control of strategically important infrastructure on sensitive land	Positive externality (or absence of negative externality)	2/3

Appendix 2. CPPIB/AIA decision: assessments of the benefit to New Zealand

Factor	Summary	OIO assessment ⁷⁹	Ministers' importance rating ⁸⁰	Ministers' assessment
S.17(2)(a)(i)	Creation or retention of jobs	Unknown	H	Unknown
S.17(2)(a)(ii)	New technology or business skills	✘	H	✘
S.17(2)(a)(iii)	Increased export receipts	Unknown	H	Unclear
S.17(2)(a)(iv)	Added market competition, greater efficiency or productivity	Unknown	H	✘ "Not persuaded"
S.17(2)(a)(v)	Introduction of additional investment	Unknown	H	Unknown
S.17(2)(a)(vi)	Increased processing of primary products	✘	N/A	N/A
S.17(2)(b)	Indigenous fauna	N/A	N/A	N/A
S.17(2)(c)	Fish and game	N/A	N/A	N/A
S.17(2)(d)	Historic heritage	✓	M	✓
S.17(2)(e)	Walking access	✓	M	✓
S.17(2)(f)	Foreshore, seabed, riverbed and lakebed offered to Crown	N/A	L	Assumed conditions met
R.28(a)	Consequential benefits	✘	H	✘
R.28(b)	Investor a key person in key industry abroad	Unknown	M	Unknown
R.28(c)	Trade and international relations	Unknown	H	No adverse consequences of refusal
R.28(d)	Further significant investment	✘	L	✘
R.28(e)	Prior investments	✘	L	✘
R.28(f)	Advancement of government policies or strategies	Unknown	H	Unknown
R.28(g)	Enhancement of other overseas investments	✘	L	✘
R.28(h)	Assist NZ to maintain NZ control of strategically important infrastructure on sensitive land	Unknown	H	✘

⁷⁹ ✓ indicates a positive assessment; ✘ a negative assessment; N/A means not applicable.

⁸⁰ H = high importance; M = medium importance; L = low or no importance. The OIO did not publish an importance rating.

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