

ENCOURAGING FOREIGN INVESTMENT BY LIMITING POLITICAL INFLUENCES

By Nora von Ingersleben and Braden Cox

Introduction

The United States currently faces the worst financial crunch and crisis since the Great Depression. Thanks to the sub-prime mortgage disaster, banks have incurred billions of dollars of losses. Write-downs, combined with the opaqueness of complex financial instruments and the decline in net worth of many borrowers resulting from a drop in house prices, have led banks to sharply reduce their lending. For small and medium-sized enterprises (SMEs) in the IT sector, this means it is much harder to raise capital to develop innovative new products, jeopardizing America's position as the most innovative and most economically successful country in the world.

Despite the dearth of capital available to U.S. companies, lawmakers in recent months have paid increased attention to the geographic origin of investments coming from outside of the United States, subjecting proposed investments from Asian and Arab countries to much stricter reviews than investments from other regions of the world.

Keeping a watchful eye on foreign investments to ensure that they don't have negative consequences for national security is certainly important. However, at the same time, policymakers need to realize that foreign direct investment (FDI) is highly beneficial for the United States and restricting it will have severe economic consequences, especially in the current climate of sharply reduced domestic credit availability. With the Committee on Foreign Investment in the United States (CFIUS), a useful tool exists for balancing safety and growth. This balance can only be achieved, however, if lawmakers refrain from making the CFIUS review process into an arena for political wrangling.

Foreign Direct Investment is Vital to the U.S. Economy

Foreign direct investment broadly defined is when a company from one country acquires a lasting management interest in a company or enterprise outside the investing firm's home country. It can take many forms, such as a direct acquisition of a foreign firm, construction of a facility, or investment in a joint venture or strategic alliance with a local firm with attendant input of technology and licensing of intellectual property.¹

Foreign direct investment benefits the United States and in particular SMEs in the technology sector. Technically, foreign investment must equal 10 percent or more of the shares or voting power in a foreign firm to qualify as foreign *direct* investment (as opposed to portfolio investment).²

The U.S. has been the historical leader in foreign direct investment. In 2006, the United States recovered its position as the largest single host country for FDI in the world, overtaking the United Kingdom. According to the United Nations Conference on Trade and Development (UNCTAD), FDI inflows into the United States were an estimated \$177.3 billion in 2006, up from only \$99.4 billion in 2005.³ That foreign firms are investing more money in the U.S. is good news for the American economy – policymakers should seek to bolster this trend instead of trying to restrict the flow of FDI coming into the United States.

FDI has a positive effect on jobs and wages in the U.S., it is an essential source of capital for innovative SMEs in the technology sector, and it allows smaller firms to internationalize and capture opportunities in foreign markets.

FDI creates new jobs, boosts U.S. wages, and brings in new research, technology and skills. In 2006, U.S. affiliates of foreign companies employed 5.3 million U.S. workers, or 4.7 percent of private industry employment, and supported an annual U.S. payroll of \$318 billion, with average annual compensation per employee of over \$60,000.⁴ Average compensation per employee within these companies has risen every year since 1992, and some studies have found that foreign companies have paid wages in the past that were as much as 15 percent higher on average than wages paid by U.S. companies.⁵ In 2003, affiliates of foreign companies spent \$30 billion on research and development (R&D) and \$109 billion on plants and equipment.⁶ These advances are often adopted by locally-owned companies.

Foreign investment also contributes to U.S. tax revenues. In 2002, foreign affiliates paid \$17.8 billion in taxes, which represented 12 percent of U.S. corporate tax revenues.⁷ What is more, the increased investment and competition from FDI leads to higher productivity growth, a key ingredient that increases U.S. competitiveness abroad and raises living standards at home.

Foreign investment allows U.S. companies to penetrate foreign markets and increase U.S. exports. Multinationals' distribution networks and knowledge about foreign tastes can be particularly helpful for U.S. companies trying to export into new markets. In 2006, approximately 21 percent of all U.S. exports came from U.S. subsidiaries of foreign companies.⁸

Foreign investment especially benefits SMEs. The benefits of foreign direct investment are especially pronounced for small- and medium-sized enterprises. The inflow of FDI increases the supply of capital for loans to businesses and individuals, thereby decreasing the cost of borrowing money for domestic entrepreneurs. This is of great importance to SMEs, which obviously have weaker financial capacities than their larger counterparts. In addition, while investing in innovative technology SMEs is often highly rewarding, it is also very risky – which means that banks prefer putting their money into larger, more established companies. This is particularly true in times of financial crisis, when banks are extremely reluctant to make high-risk investments that could have an additional negative impact on their balance sheets. For SMEs in the tech sector it is therefore of utmost importance to have a wide array of capital sources from which they can tap into to grow and compete.

Foreign investment provides essential capital to help spark the creation of innovative enterprises. Thanks to FDI, innovative American SMEs have more money to compete globally and innovate locally. FDI also gives smaller firms an opportunity for internationalization, allowing them to exploit opportunities in foreign markets that would normally have been out of reach.

FDI Rarely Raises National Security Concerns — But If So, There's CFIUS

The vast majority of foreign investment has important benefits to U.S. competitiveness and the innovative output of American businesses. These investments do not in any way pose a threat to national security; they simply reflect the desire of businesses to capture the opportunities provided by a (relatively) “flat world.”

However, in some cases, transactions involving foreign firms can raise legitimate security concerns. To make sure that no foreign investments posing a threat to national security would be allowed, the President in 1975 established the Committee on Foreign Investment in the United States (CFIUS). In 1988, CFIUS was tasked with determining whether particular foreign acquisitions of U.S. companies have national security issues sufficient to warrant a review and to undertake an investigation, if necessary, under the Exon-Florio provision.⁹

Significantly, the CFIUS process was a way to provide *nonpartisan* and *depoliticized* assessments of the impact that certain foreign acquisitions of U.S. companies would have on national security. Yet in July 2007, Congress passed the Foreign Investment and National Security Act of 2007, amending the CFIUS review procedure in a way that offers more avenues for political wrangling. The Act's reforms of the CFIUS review process include enhanced congressional reporting requirements. The Act also established stricter, more formal review procedures, such as a full 45-day national security investigation whenever a transaction involves a foreign government-controlled buyer or whenever a transaction would result in unmitigated foreign control of critical infrastructure. Reform of the CFIUS process – and the increased politicization that goes hand-in-hand with it – happened even though there is evidence that CFIUS has handled its tasks in a responsible and efficient manner in the past.

In June 2005, CNOOC, a subsidiary of state-owned China National Offshore Oil Corporation, made an unsolicited bid for California-based Unocal, which was widely seen as problematic because it could potentially have made the United States reliant on the Chinese government for oil. CNOOC asked CFIUS to begin the review process,¹⁰ but before the deal could be finalized and CFIUS could begin its review, opponents seized on what the proposed purchase of Unocal said about the Chinese government's long-term philosophy about oil markets.¹¹ The intense public scrutiny of the proposed acquisition and the motivations behind it ultimately resulted in CNOOC withdrawing its offer.¹²

Other recent deals that have received political controversy include Abu Dhabi's investment in Citibank and Borse Dubai's deal to acquire 20 percent of NASDAQ.

It is important that we trust CFIUS to do its job in a nonpolitical manner. Removing the politics from investment reviews and allowing the CFIUS process to run its course is the best way to protect our security interests while maintaining an “open for business” sign to foreign investors.¹³ Conversely, politicizing the CFIUS process sends a strong message to the world that foreign money is not welcome and will not be rewarded in the United States. During a financial crisis that has left the entire American banking system “virtually frozen”¹⁴ (and according to experts could result in lending cutbacks of as much as \$2 trillion¹⁵), this is not a message the United States can afford to send. In fact, given the importance of FDI to the American economy even during periods of financial stability, it is not a message the United States can ever afford to send.

We Should Avoid Politicizing Foreign Direct Investment

If the United States starts politicizing decisions on foreign investments, there is a real danger that other countries will do the same.

There are already a number of countries which have restrictions on investments by American firms. In October 2007, after Sudan had been a target of U.S. sanctions for ten years, the government of South Sudan¹⁶ negotiated a deal with the U.S. Office of

Foreign Assets which allows U.S. companies to invest in development of southern Sudan, but explicitly excludes American oil firms. As Finance Minister Kuol Athian put it: "Not for the oil ... but other companies can come, and they can transfer their money to [S]outh Sudan."¹⁷ Similarly, Kuwait currently maintains a variety of restrictions on foreign direct investment and applies discriminatory taxation policies.¹⁸ In Saudi Arabia, foreign firms are excluded from 13 sectors of the economy and have to pay taxes while domestic entities are only required to pay *zakat* (a charitable donation).¹⁹

Even more worryingly, negotiations on a planned free trade agreement between the United Arab Emirates (UAE) and the United States failed to produce results and were aborted in May 2006 after the U.S. refused to provide compensation to the UAE for the manner in which American authorities handled Dubai Ports World's planned acquisition of P&O and the UAE declined to open up its markets to American investments.²⁰ The politicization of foreign investment in this case resulted in lost opportunities for both American and Saudi Arabian businesses.

If the U.S. keeps injecting politics into investment reviews, this will only increase the number of cases in which other countries decide to retaliate and close their markets to American investments.

This would be a dangerous development for the United States. U.S. businesses need to invest in companies that are based overseas so that they can grow through access to superior technologies and workers and sell their products to overseas customers. FDI in diversified locations can contribute to the development of new knowledge and capabilities by providing access to various location-based advantages. As Jane W. Lu and Paul W. Beamish point out, this potential "to promote organizational learning in diverse international markets and enhance a firm's international competitiveness has been increasingly recognized as a key benefit of FDI."²¹

What is more, U.S. companies with multinational trade and investment activities also contribute substantially to productivity growth, job creation, and rising living standards in the United States. Thus, each \$10 that U.S. firms invest in other countries is associated with \$15 in additional U.S. domestic investment, and each \$10 in additional foreign employee compensation is associated with \$18 in additional U.S. domestic employee compensation.²² U.S. companies that have foreign affiliates pay their employees more than do U.S. companies that do not have foreign affiliates. In addition, studies have shown that the countries that invest extensively abroad are usually also large recipients of FDI.²³

If more countries chose to close their markets to American investments, this would be especially damaging for SMEs. According to Lu and Beamish, "FDI is an important avenue for the growth of SMEs."²⁴ Similar to exporting, FDI broadens a firm's customer base through entering into new markets, enables the firm to achieve a larger volume of production, and grow. However, while "exporting and FDI both contribute to firm growth, FDI is a more effective growth strategy in international markets than exporting. The implication is that SMEs should not curtail internationalization activities at the export stage, but explore opportunities to make FDIs to benefit from the greater growth potential associated with such investments."²⁵

In short, the politicization of foreign investment decisions mainly hurts smaller companies and might have the unintended consequence of robbing promising American startups of the opportunity to become the next Google.

Conclusion — Encourage Foreign Investment and Trust the CFIUS Process

The safety of the United States and its citizens must not take a back seat to profit. If a proposed foreign investment poses a threat to national security, U.S. lawmakers need to ensure that the investment cannot go through.

At the same time, lawmakers need to be aware of the immense damage caused by injecting politics into foreign investment decisions. At a time when U.S. banks are dealing with huge losses and uncertainties surrounding the pricing of securities, American companies need to be permitted to turn to other sources of financing.

CFIUS was created to conduct objective, non-political reviews of foreign investments that could have negative consequences for the safety of the United States and its citizens. Should CFIUS decide that a proposed investment brings with it no dangers, lawmakers need to step back.

Restricting the flow of foreign money during a credit crisis could have severe consequences for the American economy. Even during periods of financial stability, FDI brings with it a vast array of benefits for both individual companies and the economy as a whole. Innovative technology SMEs – an important engine of economic growth – are especially dependent on a constant flow of capital which can be invested into the research and development that often leads to breakthrough new products.

A seamless global economy provides enormous benefits to American consumers and businesses. These benefits are diminished when laws restrict the free flow of capital. Therefore, CFIUS should review foreign investments without interference from lawmakers interested in scoring cheap political points. In a globalized economy, political demagoguery should not undermine the kinds of deals that have helped make America the world's largest—and most successful—economy.

About ACT

The Association for Competitive Technology (ACT) is an international advocacy and education organization representing more than 3000 small and mid-size information technology firms from around the world. ACT advocates for an environment that inspires and rewards innovation, and provide resources like the Innovators Network to help members leverage their intellectual assets to raise capital, create jobs, and continue innovating.

About the Authors

Nora von Ingersleben is Policy Analyst at the Association for Competitive Technology. She holds a Bachelor's degree in Politics and Philosophy from the University of York, and a Master's degree in International Relations from the London School of Economics.

Braden Cox is Research & Policy Counsel at the Association for Competitive Technology. Braden earned a Bachelor's degree in Finance and a J.D. from the University of Georgia.

EndNotes

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- ⁹ Exon-Florio permits the President to prevent acquisitions, mergers, or takeovers of U.S. companies or assets by foreign-owned or -controlled entities when, in the President's view, such transactions threaten the national security of the United States. Parties to a transaction that potentially implicates Exon-Florio may **voluntarily** file a notification with CFIUS to give the U.S. Government an opportunity to review the transaction and address any potential national security concerns. Richard J. Vacura, Aki Bayz, and Thomas L. Eldert, "Congress Passes CFIUS Reform," *Morrison and Foerster Legal Updates and News*, July 2007, available at <http://www.mofo.com/news/updates/files/12541.html>.
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