
Executive Summary

Foreign acquisitions of American companies and assets have long been a controversial and hotly debated subject in the United States. Americans take pride in the words “made in America” and, to a lesser extent, “owned by Americans.” A March 2006 poll by The Pew Research Center for the People and the Press found that 53 percent of Americans believed that foreign ownership of US companies was “bad for America.”¹ Similarly, 58 percent agreed that Congress acted “appropriately” when it blocked the acquisition of six US port terminal operations by Dubai Ports World, a company owned by the government of the United Arab Emirates, in the spring of 2006. The subject attracted intense interest far beyond Washington and New York elites: 41 percent of Americans said that they tracked the Dubai Ports World transaction “closely,” only 2 percentage points lower than interest in the war in Iraq (43 percent). The same poll showed that the Dubai Ports World transaction ranked seventh among political stories that generated the most news interest in the last two decades, just below the 1996 federal government shutdown and the 1993 controversy over whether to allow gays in the military.

It is partly encouraging that 53 percent of Americans believed that foreign ownership of US companies was “bad for America”: In 1989 that figure stood at 70 percent. The 1989 poll was taken at a time of great uncertainty about the competitiveness of the US economy, at the height of US concerns about mergers and acquisitions from Japan, and shortly after Congress passed the Exon-Florio Amendment to the Defense Production Act in the Omnibus Trade and Competitiveness Act of 1988. The Exon-

1. The Pew Research Center for the People and the Press, *Survey Reports*, March 15, 2006, available at www.people-press.org.

Florio Amendment gave the president broad powers to block a foreign acquisition or takeover of a US company if that transaction threatened to impair US national security. That amendment and the national security implications of foreign direct investment (FDI) in the United States are the subjects of this book.

Chapter 1 traces the history of the impact of FDI on the US economy and the US reaction to FDI, particularly during World War I and II and in the late 1980s, when Exon-Florio was enacted. FDI played a significant role in the development of the US economy in the late 19th and early 20th centuries, particularly in the chemical, radio broadcasting, telecommunications, and transport machinery sectors. FDI in the United States—most of which was new, or “greenfield” investment, as opposed to an acquisition—grew to \$7.1 billion by 1914. As the United States moved toward entering the war, national security concerns arose about FDI, particularly investment from Germany. These concerns led to the passage of the Trading with the Enemy Act (TWEA) in 1917, which authorized the president to seize assets owned by foreign persons. President Woodrow Wilson invoked the TWEA in 1917 and 1918, seizing virtually all US assets owned by German companies, as well as assets owned by US citizens of German origin. The US government subsequently transferred or sold these assets, including patents for chemical products, to US companies, such as DuPont and General Electric. After World War I, Congress, encouraged by the US Navy, passed sector-specific prohibitions on FDI in radio broadcasting, telecommunications, air transport, shipping, and oil. Except for FDI in telecommunications, which was liberalized in 1996, these laws remain on the books.

President Franklin Delano Roosevelt invoked the TWEA again in 1941, though this time there were very few German assets to seize since German investment in the United States after World War I was very little. The low level of postwar German investment stemmed not only from the poor health of the German economy but also from foreign investors’ lack of confidence in US willingness to allow them to keep their holdings. Postwar FDI in the United States grew modestly, to \$2.5 billion in 1946, and investments flowed primarily from the United Kingdom and Canada. The stock of US investment abroad stood at \$7.2 billion in the same year.

By contrast, FDI in the United States grew quickly between 1956 and 1977, particularly as European economies rebounded. It grew even faster in the late 1970s and 1980s, reflecting a worldwide trend. Between 1977 and 1984, FDI in the United States grew almost thrice as fast as US investment abroad. From 1985 to 2004, the stock of FDI in the United States increased more than eightfold, from about \$185 billion in 1985 to almost \$1.7 trillion at the end of 2005.

The specific security concerns over FDI in the United States have changed since World War I. At that time the main concern was that foreign companies would dominate new, strategically important technologies. This

dominance was reflected in the fact that most FDI in the United States was of a “greenfield” nature). But since then, US firms have come to be at the cutting edge of such technologies. FDI thus has shifted away from greenfield investments and toward mergers and acquisitions, so that the modern concern is more acquisition by foreign firms of US-developed technologies than foreign-firm dominance of these technologies. Even so, in all its forms, FDI has become critical to the vibrancy and vitality of the US economy. Moreover, with rising levels of FDI in the United States have come rising concerns over its national security implications.

In chapter 2, we analyze the legislative history that led to the adoption and implementation of the Exon-Florio Amendment. As originally introduced, the amendment would have allowed the president to block investments that affected not only US national security but also essential commerce and economic welfare. The latter two provisions became the focus of intense debate and brought a threat of veto by President Ronald Reagan. President Reagan and Congress eventually agreed to narrow the bill to allow the president to block a transaction only on “credible evidence” that the foreign acquirer might take action that “threatens to impair the national security” and only if no other provision of law allowed the president to protect national interests. Congress did not define the words “national security,” and the Committee on Foreign Investment in the United States (CFIUS), the 12-agency body that reviews foreign investments, interprets this term as broadly as possible.

On multiple occasions, Congress has attempted to amend, broaden, and deepen Exon-Florio. As we go to print, the Senate Banking Committee, led by Senators Richard Shelby (R-AL) and Paul Sarbanes (D-MD), passed a bill by a 20-0 vote that would require greater scrutiny of certain acquisitions, lengthen reviews, and create much more congressional involvement in and oversight of the CFIUS process. More than 20 similar bills have been introduced in both the House and the Senate. These efforts mirror many earlier attempts to amend Exon-Florio, although at the time of this writing, it appears almost inevitable that Congress will pass legislation to amend Exon-Florio.

That Congress never defined “national security” has had important consequences, particularly after the terrorist attacks of September 11, 2001. Since then, and along with the addition of the Department of Homeland Security to CFIUS, CFIUS has more heavily scrutinized foreign investments, imposed tougher requirements before approval, and enhanced enforcement of security agreements negotiated through the Exon-Florio process. Chapter 2 discusses the security agreements CFIUS used to mitigate national security concerns in the telecommunications and defense sectors. These agreements have become increasingly intrusive and restrictive, particularly in the telecommunications sector, and have evolved according to CFIUS’s expanding view of national security. Today, CFIUS’s focus on protecting “critical infrastructure” is a high priority.

Chapter 3 examines the effects of FDI on the US economy—in particular, on US workers, research and development (R&D), long-run US economic growth, and positive or negative externalities or “spillovers.” The United States depends heavily on continued inflows of FDI, because US savings, net of the drain of public-sector deficits on these savings, are insufficient to finance domestic investment. In 2005 the current account deficit was slightly more than \$800 billion and growing, implying that the United States needed to import in excess of \$2 billion each day to close the gap between domestic investment and saving.

In 2003 US affiliates of foreign investors employed 5.3 million workers in the United States. On average, particularly within major manufacturing subsectors with significant numbers of foreign-controlled firms, US affiliates of foreign firms pay higher annual wages and salaries than US firms. Similarly, foreign-controlled firms employ at least 100,000 workers in the United States in eight manufacturing subsectors; in seven out of the eight, foreign firms pay more than the overall US average wage and salary within those subsectors. There may be some selection bias in the data, but while the extent of the wage differential can be debated, it is clear that FDI creates desirable US jobs at higher-than-average wages.

Our analysis also shows that while US parents of US-based multinational firms invest slightly more in R&D as a percentage of overall contribution to US GDP than do US affiliates of foreign-owned firms, the difference is rather small. It is rather surprising that foreign investors’ R&D spending as a percentage of value added approximates R&D spending by the parents of US-based multinationals, given that most firms tend to concentrate their R&D activities close to their worldwide headquarters, typically located in a company’s home country. In some subsectors, including computer manufacturing and communications equipment, affiliates of foreign firms spend a greater portion of value added on R&D than US parents do. While it is hard to pinpoint the precise impact of FDI on economic growth, it is closely correlated with the amount of international trade, and studies have clearly shown that increased international trade aids economic growth. Microstudies also indicate that, in some sectors at least, FDI has generated positive spillovers: For example, in the auto industry, rising productivity and improved product quality both have almost surely been stimulated by the greater competition in the United States created by the local operations of foreign-owned automobile producers.

Chapter 4 discusses the national security implications of FDI from China, which became an important issue in 2005 with the sale of IBM’s personal computing division to Lenovo and the failed attempt by the China National Offshore Oil Corporation to acquire Unocal. In less than 30 years, China has transformed itself from one of the most isolated and autarkic economies in the world to the second-largest recipient of FDI, but outward investment flows from China remain small. China’s central government, which controls significant parts of the Chinese economy, began en-

couraging Chinese enterprises to invest abroad only less than five years ago. Chinese outward investment is growing, reaching \$44.8 billion in 2004, but it pales compared with the total stock of FDI in China, which was \$562 billion in the same year.

From a broad, strategic perspective, Chinese acquisitions present CFIUS with different issues and concerns than do acquisitions by companies of other major trading partners. Of the United States' 10 largest trading partners, China is the only one not considered a strategic or political ally. Similarly, more than any other major trading or investment partner, the Chinese government owns or controls most Chinese companies with the resources and size to invest abroad. A recent study² estimates that only about 20 of approximately 1,300 publicly listed companies in China in 2004 were genuinely private; the rest were all ultimately controlled by the state. A Chinese company seeking CFIUS approval will likely have a heavy burden of convincing the committee that it is not government-controlled, and under the Byrd Amendment to Exon-Florio, CFIUS can more closely scrutinize companies owned or controlled by foreign governments.

Other factors can also lead to extra scrutiny by CFIUS of Chinese investments in the United States. The possibility of sensitive, export-controlled technology being transferred to other countries is a factor in virtually all CFIUS reviews, regardless of the home country of the acquirer. It is a particular concern for acquisitions by Chinese companies largely because of a series of high-profile breaches of US export control laws and regulations by Chinese companies in the late 1990s and early 2000s. China's espionage activities have also become a concern and a higher priority at US counter-intelligence agencies, including the Departments of Justice, Defense, and Homeland Security, as well as the Federal Bureau of Investigation. So long as the Pentagon views China suspiciously, CFIUS will likely assess Chinese acquisitions of US companies in part by their impact on China's military strength.

Notwithstanding concerns associated with Chinese investment in the United States, we believe that the Exon-Florio Amendment gives the president and CFIUS ample authority and power to scrutinize investments and mitigate national security concerns—and if such concerns cannot be mitigated, the president has ample authority to block individual transactions.

The United States should continue to support China's integration into the global economy, and Chinese outward foreign investment should be viewed as a natural and positive step in China's economic development. For close to two decades, through Republican and Democratic administrations, the United States has encouraged China to lower tariffs, eliminate nontariff barriers to trade, privatize state-owned enterprises, allow inward investment, and participate in—and play by the rules of—the global econ-

2. See testimony of Pieter Bottelier before the US-China Economic and Security Commission, April 16, 2004.

omy. A US policy that encourages American companies to invest in China, but frowns upon Chinese investment in the United States, is neither sustainable nor sound from an economic perspective. Rather, the United States should simultaneously encourage China to allow FDI and make clear that Chinese investment in the United States is not only welcome but also encouraged. Notwithstanding the serious and legitimate policy concerns related to espionage, technology transfer, and state control of many Chinese corporations, CFIUS should focus on the marginal increase in risk to US national security, if any, that a particular transaction creates. It should not try to use individual transactions to resolve the broad set of problems in the US-China economic relationship. At the same time, the president should not hesitate to block a foreign investment, from China or any other country, that genuinely threatens to impair US national security.

Chapter 5 shows how the CFIUS process has become increasingly politicized. The very nature of an Exon-Florio review involves two highly sensitive political issues: foreign ownership over US assets and national security. Each of these issues independently can grab attention, and when they combine, they can produce a combustible political mix. Companies have sought to influence or politicize the CFIUS process to raise costs for potential foreign acquirers, reopen the bidding process, or advance other commercial interests unrelated to national security. In 1990, 119 members of Congress wrote to the president asking for an investigation of the proposed hostile acquisition by the UK firm British Tire and Rubber (BTR) of the Norton Company, based in Massachusetts. Encouraged by Norton, these members of Congress suddenly changed their tune when a French company, Compagnie de Saint Gobain, bid \$15 more per share than did BTR. It is hard to see how a British acquisition of a US company raised national security concerns while a French acquisition did not. Similar examples have occurred over the last 18 years, including the uproar over Dubai Ports World's proposed acquisition of the Peninsular and Oriental Steam Navigation Company (P&O), the UK company that operated terminals at six US ports.

The catalyst for the political controversy surrounding Dubai Ports World appears to have been a small stevedoring firm based in Miami, Eller & Co. Eller had a long-standing commercial dispute with P&O and sought to block the deal to increase its leverage in its negotiations with P&O. It first tried to intervene with CFIUS, which, appropriately, decided not to factor a commercial dispute into its national security analysis. Eller then stoked the flames on Capitol Hill. A spokesperson for Senator Charles Schumer (D-NY), the leading opponent of the transaction, stated that "Eller was really the canary in the mineshaft for many people on the Hill" regarding the Dubai Ports World/P&O deal.³

3. Neil King Jr., and Gregg Hitt, "Small Florida Firm Sowed Seed of Port Dispute," *Wall Street Journal*, February 28, 2006, A3.

We conclude in chapter 5 that politicizing the CFIUS process costs the United States. It increases uncertainty for foreign investors, employees, and customers of the parties to a transaction. If the politicization of the process continues unabated, foreign investors could shy away from acquiring US companies, chilling the investment market and lowering values of US companies. A politicized review could create higher risk for foreign investors than for domestic investors because of the uncertainty associated with it. As a result, in highly politicized transactions, foreign investors could be forced to pay more for an asset than would domestic investors. Alternatively, if a domestic company seeks to be acquired by another company, and the only interested parties are foreign, the domestic company might see the value of its assets diminished because of the CFIUS process. A failed foreign transaction would also hurt the United States if the foreign investor would have brought improved technologies and new capital that enhanced productivity and job creation. All of this translates into higher costs for the US economy and, in some cases, diminished benefits.

To avoid the costs of politicization, CFIUS should make it clear that it frowns on competitors or their representatives interfering in the national security review process for commercial rather than national security reasons. Such a statement would only be hortatory, as distinguishing between commercial and national security considerations depends on the desires of the leaders of each CFIUS agency to do so. However, Congress did not set up CFIUS to block politically difficult or unpopular transactions; it intended for the president to block only those transactions that create national security risks to the United States.

Reforming the CFIUS process has become one of the top priorities for the 109th Congress in 2006. While we believe that CFIUS can be improved through changes to regulations and not the statute, pressure for changes in law seem to be so substantial that Congress is likely to pass legislation. Chapter 6 offers a number of ideas for improving Exon-Florio, as well as those that should be rejected. Improvements to the process should include

- **adding protection of critical infrastructure as a factor for CFIUS consideration.** The Department of Homeland Security has identified 12 sectors that it considers to be critical infrastructure. Together, these sectors account for 24.4 percent of US nonfarm civilian workers, a huge swath of the US economy. But if protection of critical infrastructure is going to be a high priority for the federal government, which it should be, then CFIUS, and particularly the Department of Homeland Security, should clarify exactly how it would protect critical infrastructure.
- **establishing security standards for employment of nonnationals in sensitive positions.** Traditional screening mechanisms may not be avail-

able to conduct background checks on non-American citizens or non-US employees working abroad. US security agencies can have foreign nationals employed in sensitive positions screened by their own governments or by independent screening agencies operating under the laws of a particular individual's home country. Doing so would require CFIUS to recognize the validity, through mutual recognition agreements, of background checks undertaken by friendly foreign governments.

- **enhancing disclosure of information to Congress.** CFIUS should enhance the quality and quantity of information provided to Congress on the operation of the Exon-Florio Amendment. Greater information disclosure should include aggregate rather than detailed, transaction-specific data. Congress should not demand, nor should CFIUS provide, any confidential business data that parties to a particular transaction give to CFIUS.
- **clarifying the standard by which CFIUS determines whether there is “foreign” control.** The standard by which CFIUS determines foreign control is one of the most restrictive in the US government. CFIUS agencies should clarify the critical elements of the test and consider raising the 10 percent threshold of ownership above which control is presumed.
- **developing international standards for national security review processes.** A number of countries have moved to either impose tighter national security-based restrictions on FDI or define such restrictions in broader economic and strategic terms, or both. To minimize the chilling effect on FDI of these new or expanded foreign investment review measures, members of the Organization for Economic Cooperation and Development (OECD), joined by China, India, and Russia, should develop principles that govern laws for national security-related screening processes for foreign investment.

The executive branch and Congress should also reject a number of ideas that will chill investment without enhancing national security. These include

- **establishing a mandatory filing requirement.** Creating a mandatory filing requirement is both unnecessary and inconsistent with the philosophy underlying Exon-Florio and broader US international economic priorities. Mandatory filings would completely overwhelm the CFIUS process, force CFIUS to focus on transactions that do not raise national security issues, and divert attention from cases that do raise national security concerns.
- **moving the CFIUS chair.** Designating Treasury as the CFIUS chair was consistent with the legislative intent of Exon-Florio to maintain an open

investment environment while protecting national security. No other US government agency is better equipped to chair the process than Treasury is. At the same time, Treasury should defer to security agencies with expertise on particular transactions and should strengthen its own security expertise.

- **introducing an economic security test.** The Exon-Florio Amendment is perhaps most frequently criticized for not allowing CFIUS and the president to consider economic as opposed to national security issues. Adopting an “economic security” or “economic effects” test would undermine the United States’ long-standing policy of welcoming foreign investment, be extremely difficult to implement, and further politicize the CFIUS process.

Without FDI, US manufacturing, employment, competitiveness, and innovation will all be at risk. Unless the United States remains open to foreign investment, it will alienate its allies and could find itself increasingly isolated in an increasingly interdependent world. There are those who would restrict foreign investment in the name of strengthening the economy and national security. If they have their way, the United States will lose an important source of economic vitality, resulting in the opposite of what they set out to achieve. Maintaining an open environment for FDI is in itself deeply in the national security interest of the United States.