

CRS Report for Congress

Foreign Direct Investment: Current Issues

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Foreign Direct Investment: Current Issues

Summary

The United States is the largest recipient of foreign direct investment in the world and the largest investor abroad. As a result of this dual role, the United States has led negotiations in various international forums to remove restrictions on foreign investment and other market-distorting measures to maximize the benefits of such investment. In 2006, foreign investors spent \$184 billion investing in U.S. businesses and real estate, the highest amount foreign investors have spent since 2000.

Within the economy, foreign direct investment is sparking a mixed reaction. Although the environment for foreign investors is still friendly, some Members of Congress and some in the public argue that the events of September 11, 2001, raise new concerns about the nation's economic security that challenges the traditionally open policy the United States has had toward foreign investment, particularly foreign investment in critical industries and in sectors that are vital to homeland security. As part of these concerns, Congress is considering legislation that would revamp the Committee on Foreign Investment in the United States (CFIUS), an interagency committee housed in the Treasury Department that has served Presidents since 1975 as the chief federal government organization responsible for overseeing the national security implications of foreign investment in the economy. In contrast to these actions, the International Trade Administration of the Department of Commerce announced on March 7, 2007, that it was creating a new initiative: *Invest in America*. The initiative appears to depart from the long-standing U.S. policy of official neutrality toward inward and outward direct investment by having the federal government actively internationally promoting the United States as a foreign direct investment destination. It also will serve as the primary U.S. government mechanism responsible for managing inward investment.

This report presents an overview of current issues related to foreign direct investment in the economy and the development of U.S. policy toward inward and outward direct investment. This report also assesses the role of foreign direct investment in the economy and the costs and benefits of direct investment. This report will be updated as events warrant.

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Foreign Direct Investment: Current Issues

Overview

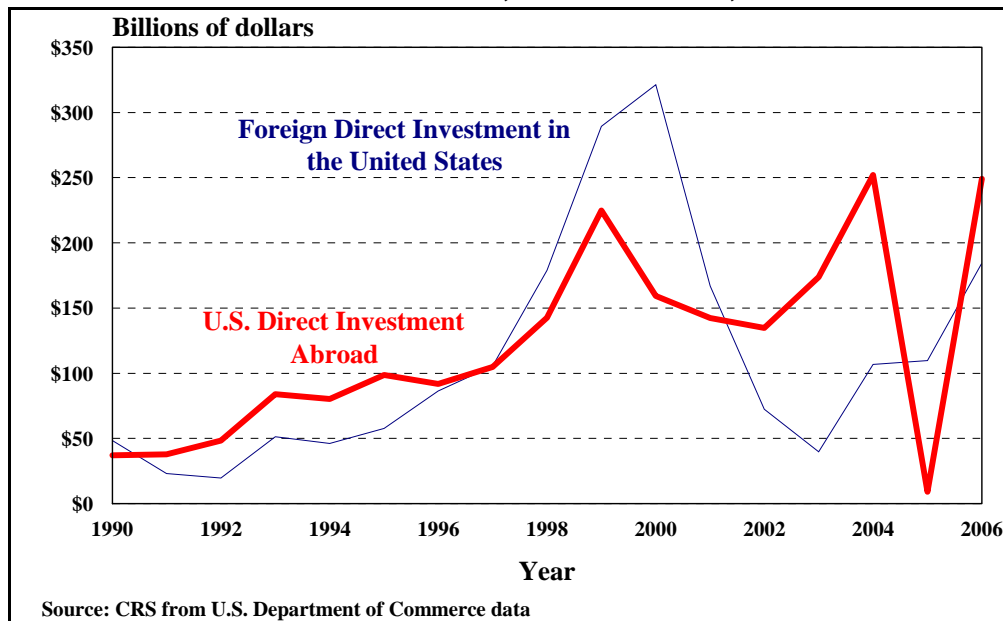
In 2006, the proposed acquisitions of major operations in six major U.S. ports by Dubai Ports World (DP World) and of Unocal by the China National Offshore Oil Corporation (CNOOC) sparked intense concerns among some Members of Congress and generated a debate over what role foreign investment, particularly foreign acquisitions of certain types of firms, plays in U.S. national security. The United States actively promotes the national treatment of foreign investors as an international standard. This open-door policy stands in marked contrast to several provisions of law, various Executive Orders, and extensive efforts aimed at limiting foreign access to the Nation's industrial base, especially in sectors deemed to be critical to the economy or to areas of importance to national security. In addition, some Members of Congress and others are concerned about the extent to which foreign government-owned companies should be allowed access to the Nation's industrial base and technology through foreign direct investment.

The United States is unique in that it is the largest foreign direct investor in the world and also the largest recipient of foreign direct investment. This dual role means that globalization, or the spread of economic activity by firms across national borders, has become a prominent feature of the U.S. economy and that through direct investment the U.S. economy has become highly enmeshed with the broader global economy. Foreigners invested \$184 billion in U.S. businesses and real estate in 2006, according to balance of payments data published by the Department of Commerce.¹ As **Figure 1** shows, this represents an increase over the amount invested in 2005 and stands in stark contrast to the sharp increase in the amount U.S. firms invested abroad in 2006 compared with the amount they invested abroad in 2005. The increase in foreign direct investment flows mirrors a turn-around in global flows. According to the United Nation's *World Investment Report*,² global foreign direct investment flows increased by 29% in 2005 and 27% in 2004, after three years of declining flows.

¹ Bach, Christopher L., U.S. International Transactions in 2006. *Survey of Current Business*, April 2007, p. 46. Direct investment data reported in the balance of payments differ from capital flow data reported elsewhere, because the balance of payments data have not been adjusted for current cost adjustments to earnings.

² United Nations Conference on Trade and Development, *World Investment Report 2006*, United Nations, 2006. P. 3.

Figure 1. Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, Annual Flows, 1990-2006



Note: The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent companies to take advantage of a one-time tax provision.

The cumulative amount, or stock, of foreign direct investment in the United States on a historical cost basis³ increased by \$109 billion in 2005 to total \$1.6 trillion. Based on Commerce Department data, foreign direct investment was \$184 billion in 2006. This marks an increase over the previous year and a significant change from the decline in foreign investment spending that has occurred since 2000.⁴ The rise in the value of foreign direct investment includes an upward valuation adjustment of existing investments and increased investment spending that was driven by the relatively stronger growth rate of the U.S. economy, the worldwide resurgence in cross-border merger and acquisition activity, and investment in the U.S. manufacturing, information and depository institutions as overseas banks

³ The position, or stock, is the net book value of foreign direct investors' equity in, and outstanding loans to, their affiliates in the United States. A change in the position in a given year consists of three components: equity and intercompany inflows, reinvested earnings of incorporated affiliates, and valuation adjustments to account for changes in the value of financial assets. The Commerce Department also publishes data on the foreign direct investment position valued on a current-cost and market value bases. These estimates indicate that foreign direct investment increased by \$147 billion and \$93 billion in 2005, respectively, to \$1.9 and \$2.8 trillion.

⁴ Koncz, Jennifer L., and Daniel R. Yorgason, Direct Investment Positions for 2005: Country and Industry Detail, *Survey of Current Business*, July, 2006. p. 20.

and finance and insurance companies sought access to the profitable U.S. financial market.⁵

New spending by U.S. firms on businesses and real estate abroad, or U.S. direct investment abroad,⁶ fell sharply in 2005 to \$9 billion, down from the \$252 billion U.S. firms invested in 2004, according to the Department of Commerce.⁷ The 2005 drop in U.S. direct investment abroad reflected actions by U.S. parent firms to reduce the amount of reinvested earnings going to their foreign affiliates for distribution to the U.S. parent firms in order to take advantage of one-time tax provisions in the American Jobs Creation Act of 2004 (P.L. 108-357). Data indicate that U.S. direct investment abroad in 2006 rebounded to reach \$249 billion.

U.S. Policy Toward Direct Investment

With some exceptions for national security,⁸ the United States has long been considered one of the most receptive economies in the world to foreign direct investment. Indeed, over the past 50 years, the United States has led efforts to negotiate internationally for reduced restrictions on foreign direct investment, for greater controls over incentives offered to foreign investors, and for equal treatment under law of foreign and domestic investors. In 1977, the Carter Administration issued a policy statement on foreign direct investment that can be summarized by the neutrality clause: the United States will neither encourage nor discourage the inflow or outflow of international investment. The policy statement also indicated that:

international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces; there is no basis for concluding that a general policy of actively promoting or discouraging international investment would further the U.S. national interest; unilateral U.S. Government intervention in the international investment process could prompt counteractions by other governments with adverse effects on the U.S. economy and U.S. foreign policy; and the United States has an important interest in seeking to assure that established investors receive equitable and non-discriminatory treatment from host governments.⁹

⁵ McNeil, Lawrence R., Foreign Direct Investment in the United States: New Investment in 2005, *Survey of Current Business*, June 2005, p. 32-33.

⁶ The United States defines direct investment abroad as the ownership or control, directly or indirectly, by one person (individual, branch, partnership, association, government, etc.) of 10% or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise. 15 CFR § 806.15 (a)(1).

⁷ Bach, Christopher L., U.S. International Transactions in 2006. *Survey of Current Business*, April 2007, p. 46. Direct investment data reported in the balance of payments differ from capital flow data reported elsewhere, because the balance of payments data have not been adjusted for current cost adjustments to earnings.

⁸ CRS Report RL33103 *Foreign Investment in the United States: Major Federal Statutory Restrictions*, by Michael V. Seitzinger.

⁹ U.S. Congress. House of Representatives. Committee on Government Operations. *The* (continued...)

This statement is based on an assessment that the free flow of international investment generally will result in the most efficient allocation of economic resources if it is allowed to flow according to market forces. During the Reagan Administration, the neutrality statement was clarified to include three related objectives. These objectives include the liberalization of barriers and the reduction of distortions to international investments abroad, the encouragement of a greater role for private foreign investment in the economic development of less developed countries (LDCs), and the maintenance of the maximum degree of openness of the U.S. economy to the contribution of foreign direct investment.¹⁰

The Clinton Administration's policy toward inward and outward direct investment can best be characterized by its support for the Multilateral Agreement on Investment (MAI).¹¹ The Agreement was expected to be a comprehensive international agreement on foreign investment among the most economically developed countries in the world, as represented by the Organization for Economic Cooperation and Development (OECD). In addition, the Agreement was intended to address various issues, including formal barriers to direct investment, discriminatory treatment, dispute settlement mechanisms, and legal and regulatory uncertainties abroad, that hamper the flow of investment funds. Ultimately, a range of unresolved issues among the OECD Ministers combined with concerns by some groups in the United States to undermine support for the Agreement. In particular, some groups were concerned that the requirement for "national treatment" in the Agreement could have created legal problems for state and local governments that enforce environmental, labor, and other corporate practices that could have been considered discriminatory.

On May 10, 2007, President Bush released his policy statement on open economies.¹² The statement offered strong support for the international flow of direct investment. In part, the statement reads:

A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. The threat of global terrorism and other national security challenges have caused the United States and other countries to focus more intently on the national security dimensions of foreign investment. While my Administration will continue to take every necessary step to protect national security, my Administration recognizes that our prosperity and security are founded on our country's openness.

⁹ (...continued)

Operations of Federal Agencies in Monitoring, Reporting on, and Analyzing Foreign Investments in the United States. Hearings. 96th Cong., 1st Sess., Part 3, July 30, 1979. Washington, U.S. Govt. Print. Off., 1979. pp. 60-61.

¹⁰ Public Papers of the Presidents of the United States. Ronald Reagan, 1983, Book II, p. 1243-1248.

¹¹ *Economic Report of the President*, February 1998. pp. 258-260.

¹² President Bush's statement is available at [<http://www.whitehouse.gov/news/releases/2007/05/20070510-3.html>].

As both the world's largest investor and the world's largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for U.S. investors abroad. Both inbound and outbound investment benefit our country by stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness that allows our companies and their workers to prosper at home and in international markets. My Administration is committed to ensuring that the United States continues to be the most attractive place in the world to invest. I urge other nations to join us in supporting an open investment policy and protecting international investments.

In addition to this statement of general support, the Bush Administration issued a policy statement that commits the Administration to four objectives:

- Reinforce the principle that a domestic climate conducive to foreign investment strengthens national security. Meeting the challenges of a post-9/11 world need not require securing one at the expense of the other. The United States recognizes that growing inflows of foreign investment are necessary to expand levels of employment, innovation, and competitiveness in this country. Only those safeguards that are clearly necessary to protect our national security should be maintained.
- Actively target unreasonable and discriminatory barriers to investment. The United States encourages a broad acceptance of the national-treatment principle in all countries and places a premium on the protection of U.S. investments abroad. The United States opposes measures that distort international investment flows, including trade-related or other performance requirements, discriminatory treatment of foreign investment, and expropriation without compensation. In turn, when countries promise to protect investment and eliminate such distortions, investors must have the ability to enforce those binding promises in neutral international settings that are free from the political intervention of governments. Further, countries need to be responsive to the needs of investors for access to innovative cross-border financial services. The United States will continue to allow foreign investors open and fair access to investment opportunities under our statutes and regulations and in accordance with international law, and will continue to welcome investment through programs such as the Invest in America initiative.
- Work with our partners in the WTO to strengthen the rules-based trading system so that it continues to promote open markets, trade reform and new opportunities for development and growth. My Administration is committed to completing the Doha Development Round with an agreement that opens markets for goods and services, ensures reform of agriculture and strengthens WTO rules, including in key areas

such as trade facilitation. The predictability, certainty, and transparency of the system enhance opportunities for international investment by building investor confidence.

- Promote an international environment in which international investment can make the greatest contribution to the development process. The United States has initiated the Millennium Challenge Account, which assists developing countries that create and maintain sound policy environments, including governing justly, investing in people, and encouraging economic freedoms. Through our bilateral and multilateral economic assistance programs, the United States will continue to explore ways to increase both public and private capital flows and support international investment in the developing world. As countries continue to adopt free market principles and democratic reforms, international investment is necessary to nurture market-oriented development and reduce debt service burdens. Economic freedom is one of the single greatest antidotes to poverty worldwide, and a positive link exists between the liberalization of investment flows and greater international trade.¹³

Exon-Florio Provision

While U.S. policy toward inward and outward direct investment generally has adhered to the overall objective of treating such investment impartially, there have been a number of notable exceptions. In 1988, Congress approved the Exon-Florio provision as part of the Omnibus Trade Act.¹⁴ The Exon-Florio provision grants the President broad discretionary authority to take what action he considers to be “appropriate” to suspend or prohibit proposed or pending foreign acquisitions, mergers, or takeovers “of persons engaged in interstate commerce in the United States” which “threaten to impair the national security.” In this act, national security was not defined, but was meant to be interpreted broadly. Through Executive Order 12661, President Reagan implemented provisions of the Omnibus Trade Act, and he delegated his authority to administer the Exon-Florio provision to the Committee on Foreign Investment in the United States (CFIUS),¹⁵ particularly to conduct reviews of foreign investment, to undertake investigations, and to make recommendations. The Committee has 30 days to decide whether to investigate a case and an additional 45 days to make its recommendation. Once the recommendation is made, the President has 15 days to act.

¹³ Ibid.

¹⁴ P.L. 100-418, title V, Subtitle A, Part II, or 50 U.S.C. app 2170.

¹⁵ Executive Order 12661 of December 27, 1988, 54 F.R. 779.

Trade Act of 2002

In the Trade Act of 2002 (P.L. 107-210), U.S. policy toward foreign direct investment was clarified through a list of objectives that are intended to direct the work of U.S. trade negotiations on foreign investment. In particular, U.S. negotiators were directed to “reduce or eliminate artificial or trade-distorting barriers to foreign investment, while ensuring that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States, and to secure for investors important rights comparable to those that would be available under United States legal principles and practice.” In order to accomplish these objectives, the act specifies eight issues, including reducing or eliminating exceptions to the principle of national treatment; freeing the transfer of funds relating to investments; reducing or eliminating performance requirements, forced technology transfers, and other unreasonable barriers to the establishment and operation of investments; establishing standards for expropriation and compensation for expropriation; establishing standards for fair and equitable treatment; providing meaningful procedures for resolving investment disputes; improving mechanisms used to resolve disputes between an investor and a government; and ensuring the fullest measure of transparency in the dispute settlement mechanism.

September 11, 2001

Arguably, the events of September 11, 2001, have reshaped Congressional attitudes toward the Exon-Florio provision that became apparent in 2006 as a result of the public disclosure that Dubai Ports World¹⁶ was attempting to purchase the British-owned P&O Ports,¹⁷ with operations in various U.S. ports. After the September 11th terrorist attacks Congress passed and President Bush signed the USA PATRIOT Act of 2001 (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism).¹⁸ In this act, Congress provided for special support for “critical industries,” which it defined as:

systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.¹⁹

¹⁶ Dubai Ports World was created in November 2005 by integrating Dubai Ports Authority and Dubai Ports International. It is one of the largest commercial port operators in the world with operations in the Middle East, India, Europe, Asia, Latin America, the Caribbean, and North America.

¹⁷ Peninsular and Oriental Steam Company is a leading ports operator and transport company with operations in ports, ferries, and property development. It operates container terminals and logistics operations in over 100 ports and has a presence in 18 countries.

¹⁸ P.L. 107-56, title X, Sec. 1014, October 26, 2001; 42 U.S.C. Sec. 5195c(e).

¹⁹ Ibid.

This broad definition is enhanced to some degree by other provisions of the act, which specifically identify certain sectors of the economy that are likely candidates for consideration as critical infrastructure. These sectors include telecommunications, energy, financial services, water, transportation sectors,²⁰ and the “cyber and physical infrastructure services critical to maintaining the national defense, continuity of government, economic prosperity, and quality of life in the United States.”²¹ The following year, Congress adopted the language in the Patriot Act on critical infrastructure into The Homeland Security Act of 2002.²²

By adopting the terms “critical infrastructure” and “homeland security,” following the events of September 11, 2001, Congress demonstrated that the attacks fundamentally altered the way many policymakers view the concept of national security. As a result, many policymakers have concluded that economic activities are a separately identifiable component of national security. In addition, many policymakers apparently perceive greater risks to the economy rising from foreign investments in which the foreign investor is owned or controlled by foreign governments as a result of the terrorist attacks. The Dubai Ports World case, in particular, demonstrated that there was a difference between the post-September 11 expectations held by many in Congress about the role of foreign investment in the economy and of economic infrastructure issues as a component of national security and the operations of CFIUS. For some Members of Congress, CFIUS seemed to be out of touch with the post-September 11, 2001 view of national security, because it remains founded in the late 1980s orientation of the Exon-Florio provision, which views national security primarily in terms of national defense and downplays or even excludes a broader notion of economic national security.

Special Security Arrangements

Much of the recent debate concerning foreign direct investment in the U.S. economy has focused on the activities of the Committee on Foreign Investment in the United States and on the Exon-Florio provision. The CFIUS process, however, is just one of three major provisions of law that authorize the review of foreign direct investment transactions for their impact on the economy. The National Industrial Security Program and the critical industries provisions of various statutes also require that foreign direct investment transactions are reviewed. Generally, the reviews mandated by these three provisions operate independently, although at times they have overlapped. The provisions illustrate the complexities involved in defining most economic activities, which can span a broad range of economic activities and fields. Most economic activities affect various sectors and segments of the economy in ways that defy a narrow definition and complicate efforts to distinguish those economic activities that are related to the broad rubric of national security or to national economic security, which is even less clearly defined.

²⁰ 42 U.S.C. Sec. 5195c(b)(2).

²¹ 42 U.S.C. Sec. 5195c(b)(3).

²² 6 U.S.C. Sec. 101(4).

Activity within Congress and the intense public and congressional reaction that arose from the proposed Dubai Ports World acquisition spurred the Bush Administration in late 2006 to make an important administrative change in the way CFIUS reviews foreign investment transactions. CFIUS and President Bush approved the acquisition of Lucent Technologies, Inc. by the French-based Alcatel SA, which was completed on December 1, 2006. Before the transaction was approved by CFIUS, however, Alcatel-Lucent was required to agree to a national security arrangement, known as a Special Security Arrangement, or SSA, that restricts Alcatel's access to sensitive work done by Lucent's research arm, Bell Labs, and the communications infrastructure in the United States.

The most controversial feature of this arrangement is that it allows CFIUS to reopen a review of the deal and to overturn its approval at any time if CFIUS believes the companies "materially fail to comply" with the terms of the arrangement. This marks a significant change in the CFIUS process. Prior to this transaction, a CFIUS review or investigation had been portrayed, and had been considered, to be final. As a result, firms were willing to subject themselves voluntarily to a CFIUS review, because they believed that once an investment transaction was scrutinized and approved by the members of CFIUS the firms could be assured that the investment transaction would be exempt from any future reviews or actions. This administrative change, however, means that a CFIUS determination may no longer be a final decision and it adds a new level of uncertainty to foreign investors seeking to acquire U.S. firms. A broad range of U.S. and international business groups are objecting to this change in the Bush Administration's policy.²³

Invest in America

On March 7, 2007, the International Trade Administration (ITA) announced that it will undertake a new *Invest in America* initiative aimed at attracting foreign direct investment.²⁴ In making this announcement, ITA officials argued that:

...the United States does not have a federal government program to attract or retain inward foreign investment. All other major economies have mechanisms such as investment boards and investment promotion activities to encourage FDI... This historically passive role toward FDI is increasingly anachronistic.²⁵

These officials also indicated that:

²³ Kirchgaessner, Stephanie, US Threat to Reopen Terms of Lucent and Alcatel Deal Mergers, *Financial Times*, December 1, 2006. p. 19; Pelofsky, Jeremy, Businesses Object to US Move on Foreign Investment, *Reuters News*, December 5, 2006.

²⁴ The United States defines foreign direct investment as the ownership or control, directly or indirectly, by one foreign person (individual, branch, partnership, association, government, etc.) of 10% or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise. 15 CFR § 806.15 (a)(1).

²⁵ Lavin, Frank L., *Role of Foreign Investment in U.S. Economic Growth*, March 7, 2007. P. 1. Available at [http://trade.gov/press/speeches/lavin_030707.asp].

...if we do not play an active role in promoting inward investment, we are at risk of having our investment climate perceived around the world only by the occasional difficulty...The United States Government needs to take the role of FDI seriously. We need to make clear that as a matter of policy, we welcome foreign investment in the United States.

According to the ITA announcement, the initiative will have three key responsibilities: (1) outreach to the international investment community; (2) serve as an ombudsman in Washington, DC, for the concerns of the international investment community as well as work on policy issues that affect the attractiveness of the United States to foreign investment; and (3) supporting state and local governments engaged in foreign investment promotion. In addition to these responsibilities the initiative is to create a task force within the International Trade Administration to educate and coordinate the efforts of ITA employees in offices around the world on foreign investment. There is no indication so far if any additional budgetary resources may be necessary to accomplish the goals of this initiative.

According to the ITA, attracting foreign direct investment to the U.S. economy is important for the following reasons.

- Foreign direct investment creates jobs in the economy: the U.S. affiliates of foreign companies employ 5.5 million U.S. workers.
- It boosts wages because the U.S. affiliates of foreign companies tend to pay higher wages than U.S. companies.
- Foreign direct investment strengthens U.S. manufacturing: 41 percent of the jobs related to U.S. affiliates of foreign companies are in the manufacturing sector.
- Foreign direct investment brings in new research, which often is adopted by locally-owned companies.
- Such investment contributes to rising U.S. productivity:
- Foreign direct investment contributes to U.S. tax revenues In 2004, foreign affiliates paid \$44 billion in taxes.
- Foreign direct investment can help U.S. companies penetrate foreign markets and increase U.S. exports.
- Inward investment helps keep U.S. interest rates low, because the inflow of foreign capital decreases the cost of borrowing money for domestic firms.

Legislation in the 110th Congress

During the 109th Congress, Members introduced over two dozen measures²⁶ to address various issues with foreign direct investment in the United States following the proposed acquisition by Dubai Ports World. Of the measures that were introduced, **H.R. 5337** and **S. 3549** from the House and Senate, respectively, garnered significant support and passed their respective bodies on July 26, 2006. The 109th Congress ended before a Conference Committee was convened on H.R. 5337 or S. 3549 and both measures lapsed. In the 110th Congress, Congresswoman Maloney introduced **H.R. 556**, the National Security Foreign Investment Reform and Strengthened Transparency Act of 2007, which was adopted by the full House on February 28, 2007.²⁷ The measure reflects a heightened level of concerns about the presence of foreign investors in the economy by increasing Congressional oversight over federal reviews of foreign direct investment and by expanding the current areas of review to include homeland security and critical infrastructure.

The measure would change current procedures to require CFIUS to investigate all foreign investment transactions in which the foreign person is owned or controlled by a foreign government, regardless of the nature of the business. Foreign investors may regard this approach as an important policy change by the United States toward foreign investment. Currently, foreign investment transactions are presumed to be acceptable and to provide a positive contribution to the economy. As a result of this presumption, the burden is on the members of CFIUS to prove that particular transactions threaten national security. Foreign investors, however, might view H.R. 556 as reversing current policy, because it shifts the burden onto firms to prove that they are not a threat to national security because they are owned or controlled by a foreign government. Although the number of investment transactions a year in which the foreign investor is associated with a foreign government is small compared with the total number of foreign investment transactions, foreign investors and foreign governments likely will view this as a significant change in the traditional U.S. approach to foreign investment.

The measure would increase the role of congressional oversight by requiring greater reporting by CFIUS on its actions either during or after it completes reviews and investigations and by increasing reporting requirements on CFIUS. The measure would require CFIUS to provide Congress with a greater amount of detailed information about its operations and it would amend the current statute regarding the meaning of national security. The bill would explicitly require the Director of National Intelligence to conduct reviews of any investment that posed a threat to the national security. The bill also provides for additional factors the President and CFIUS would be required to use in assessing foreign investments. In particular, the bill would add implications for the nation's critical infrastructure as a factor for reviewing or investigating an investment transaction.

²⁶ CRS Report RL33312, *The Exon-Florio National Security Test for Foreign Investment*, by James K. Jackson.

²⁷ CRS Report RL33856, *Exon-Florio Investment Provision: Overview of H.R. 556*, by James K. Jackson.

Federal-State Relations

U.S. policy toward foreign direct investment also has been complicated by the interplay between state and local governments and the federal government. Since the end of World War II, U.S. policy toward direct investment has been one of neutrality by the federal government, while leading international negotiations to reduce restrictions by other countries on U.S. direct investment abroad. At home, the federal government has taken no role in coordinating or regulating the activities of state and local governments as they have developed and carried out their individual approaches toward attracting foreign direct investment to their jurisdictions.

More than two-thirds of state government and numerous local governments have developed their own initiatives to attract foreign investors to their jurisdictions. Indeed, numerous jurisdictions have offered foreign firms tax and financial incentives and they have competed against other jurisdictions for the investment dollars and jobs that accompany such foreign investment. This conflict between the federal government's stance of neutrality relative to the aggressive actions of state and local governments in attracting foreign investment has been criticized by other foreign governments that question the value of entering into agreements with the federal government without being guaranteed that the federal government will exercise control over the activities of state and local governments. In addition, these governments have questioned the motives of U.S. negotiators who have pressed them in international forums to eliminate the various tax and financial benefits they offer multinational firms to locate within their jurisdictions, because they argue that such incentives distort the investment market. At the same time, they argue that the U.S. federal government seemingly makes no effort to curtail the considerable tax and financial incentives many state and local governments offer to win foreign investment commitments. It is unclear how the *Invest in America* initiative will coordinate with state and local governments that are accustomed to operating on their own and to competing fiercely with one another in attracting foreign investors.

Foreign Direct Investment in the U.S. Economy

Foreigners invest in the U.S. economy in a number of ways and for a number of reasons. These investments can be divided roughly into two broad categories, portfolio investments, or investments in corporate stocks and bonds and U.S. government securities, and direct investment, or investments in U.S. businesses and real estate. In 2006, foreigners invested nearly \$1.8 trillion dollars in the U.S. economy, \$184 billion of which was in direct investment, with the rest of the funds invested in the broader category of portfolio investment. Typically, the Department of the Treasury tracks portfolio investments since a substantial part of these investments is in U.S. Treasury securities. The Treasury Department has shared responsibilities for tracking direct investment with the Department of Commerce, because the Commerce Department's Bureau of Economic Analysis conducts surveys of direct investment that provide the basic data on such investments. The Treasury Department, however, takes the lead in negotiating international agreements on the treatment of direct investment and it chairs the inter-agency Committee on Foreign Investment in the United States, which represents the President as the chief federal

government organization responsible for overseeing the national security implications of foreign investment in the economy.²⁸

The United States is widely recognized as the premier location for foreign firms to invest, as evidenced by the data in **Table 1**. According to the United Nation's *World Investment Report*, the United States had received a cumulative amount of \$1.6 trillion in foreign direct investment by year-end 2005, twice as large as the United Kingdom, the next single largest host to foreign direct investment, and it accounted for 16% of the total cumulative amount of foreign direct investment among all nations. The United States is also the largest foreign investor in the world, with over \$2 trillion invested abroad. According to the U.N. report, of the \$10.1 trillion in the total cumulative amount of foreign direct investment among all nations, the most economically advanced developed economies were host to 70% of this amount. From 1980 to 1990, this share increased sharply from 56% of total amount of foreign direct investment to 79%. From 1990 to 1995, the developed country share fell slightly to about 70%, where it has stayed relatively stable over the past decade.

The Costs and Benefits of Foreign Direct Investment

Generally, economists conclude that direct investment benefits both the home and the host country and that the benefits of such investment outweigh the costs. Some groups within the U.S. economy, however, are concerned about the potentially negative effects of inward and outward direct investment. Most economists argue that free and unimpeded international flows of capital, such as direct investment, positively affect both the domestic (home) and foreign (host) economies. For the home country, direct investment abroad benefits individual firms, because firms that invest abroad are better able to exploit their existing competitive advantages and are able to acquire additional skills and advantages. This tends to further enhance the competitive position of these firms both at home and abroad and shifts the composition and distribution of employment within the economy toward the most productive and efficient firms and away from the less productive firms.

Table 1. Foreign Direct Investment Inward Position
(in billions of U.S. dollars)

	1980	1985	1990	1995	2000	2005
World	\$692.7	\$972.2	\$1,789.3	\$2,992.1	\$5,803.0	\$10,129.7
Developed Economies	390.7	569.7	1,416.9	2,035.8	3,976.2	7,117.1
Western Europe	231.5	285.0	815.2	1,213.0	2,297.8	4,731.3
European Union	216.3	267.1	768.2	1,136.0	2,179.7	4,499.1
France	25.9	36.7	86.8	191.4	259.8	600.8
Germany	36.6	36.9	111.2	192.9	271.6	502.8

²⁸ The focus of this report is on direct investment. For information about portfolio investment in the economy, see CRS Report RL32462, *Foreign Investment in U.S. Securities*, by James K. Jackson.

United Kingdom	63.0	64.0	203.9	199.8	438.6	816.7
United States	83.0	184.6	394.9	535.5	1,256.9	1,625.7
Canada	54.2	64.7	112.8	123.3	212.7	356.9
Developing Economies	302.0	402.5	370.3	916.7	1,756.5	2,757.0
Africa	32.0	33.8	58.4	77.3	151.0	264.5
Latin America	50.4	80.1	118.1	200.1	539.0	937.4
Asia	219.5	288.5	380.2	636.5	1,066.4	1,555.1

Source: *World Investment Report*, United Nations Council on Trade and Development, various issues.

Some observers argue that U.S. direct investment abroad supplants U.S. exports, jobs, and research and development funds, thereby reducing employment and wages in the U.S. economy. Others are concerned that outward direct investment alters the industrial composition of domestic production and trade flows, which can affect the sectoral and regional distribution of employment and the relative demand for skilled and unskilled labor.²⁹ For the home country, overseas investment may lead some firms to shift parts of their production abroad, thereby supplanting some domestic production with imports from abroad, but most studies indicate that, on balance, direct investment abroad increases U.S. exports and helps sustain employment and wages at home.³⁰ Intra-company trade is a relatively new feature of the U.S. economy, but can be expected to increase as the economy becomes even more globalized. In 2004, U.S. parent companies accounted for more than half of all U.S. exports and more than one-third of U.S. imports. Furthermore, about half of the exports by U.S. parent companies was to their foreign affiliates. At the same time, the U.S. affiliates of foreign firms accounted for 20% of U.S. exports and 25% of U.S. imports.

Globally, a relatively small share of the production of U.S. foreign affiliates makes its way back into the U.S. economy. In 2004 the foreign affiliates of U.S. multinational firms exported about 10% of their production back to the United States, but two-thirds of their production was sold within the host country and the rest was exported to other foreign countries.³¹ Foreign direct investment also supports U.S. exports to areas where formal restrictions to exports exist. In addition, by expanding and supporting development in foreign markets, direct investment spurs improvements in foreign economies, which in turn, creates new markets for U.S. goods. Direct investment also seems to be associated with a strengthened competitive position, a higher level of skills of the employees, and higher incomes of firms that invest abroad.

²⁹ *International Investment Perspectives: 2006 Edition*, the Organization for Economic Cooperation and Development. p. 99.

³⁰ *Ibid.*, p. 101; Brainard, S. Lael, and David A. Riker, *Are U.S. Multinationals Exporting U.S. Jobs?* NBER Working Paper 5958, National Bureau of Economic Research, March 1997.

³¹ Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Preliminary Results of the 2004 Benchmark Survey*, August 2006. Table III.F1.

As a host country, the United States benefits from inward direct investment because the investment adds permanently to the Nation's capital stock and skill set. Direct investment also brings technological advances, since firms that invest abroad generally possess advanced technology, processes, and other economic advantages. Such investment also boosts capital formation, contributes to a growth in a competitive business environment and to productivity. In addition, direct investment contributes to international trade and integration into the global trading community, since most firms that invest abroad are established multinational firms.³²

On the cost side, critics of foreign investment argue that some U.S. firms may invest abroad, and thereby shift some resources from activities within the United States, in order to take advantage of abundant natural resources, low-cost labor, or relaxed environmental and labor laws.³³ Indeed, about one-third of U.S. direct investment abroad is in developing countries, where economic conditions are markedly different from those in the United States or in many parts of Europe. In some cases, firms that invest abroad may shift production from the United States to a foreign location from which it might export back to the United States products that it previously had produced in the United States, but this does not seem to be a major activity of the foreign affiliates of U.S. firms. Such offshoring of production, or globalization, has grown over the last decade as many developing economies have dropped formal restrictions on foreign investment, but much of this investment seems to be geared toward producing for the local market, or for exports to neighboring countries.

The data in **Table 2** show the extent and influence of U.S. and foreign multinational firms in the U.S. economy. In 2004, the latest year for which comprehensive data are available, foreign firms had a total of 5,270 affiliates operating in the United States. These affiliates were present in every State and in every economic activity, where such activity is not prohibited by law. Foreign firms employed 5.6 million U.S. workers and paid \$350 billion in wages and compensation for an average of \$63,000 per worker, nearly twice as much as the average compensation of \$37,000 paid by the foreign affiliates of U.S. multinational firms and higher than the average of \$58,000 paid by U.S. parent companies operating in the United States. Foreign firms have a direct investment presence in every state. In 2004, 40% of the foreign firms' employment was in the manufacturing sector, more than twice the share of manufacturing employment in the U.S. economy as a whole. By comparison, U.S. multinational companies employed over 21 million workers in the U.S. economy and the foreign affiliates of these U.S. parent companies employed over 10 million workers in 24 thousand firms abroad. The foreign affiliates of U.S. firms had 60% more in the value of their gross product, had a greater value of assets, higher sales, and paid three times as much in taxes.

³² Such linkages appear to be important factors for both developed and developing host countries, see Alfaro, Laura, Areendum Chanda, Sebnem Kalemli-Ozcam, and Selin Sayek, *How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on linkages*. Working Paper 12522, September 2006, National Bureau of Economic Research.

³³ *World Investment Report: 2006*, United Nations Council on Trade and Development. p. 155-162.

The affiliates of foreign firms spent \$124 billion in the United States in 2004 on new plant and equipment, imported \$393 billion in goods and services and exported \$164 billion in goods and services. Since 1980, the total amount of foreign direct investment in the economy has increased eight-fold and nearly doubled as a share of U.S. gross domestic product (GDP) from 3.4% to 6.4%. It is important to note, however, that these data do not imply anything in particular about the role foreign direct investment has played in the rate of growth of U.S. GDP.

Table 2. Select Data on U.S. Multinational Companies and on Foreign Firms Operating in the United States, 2004
(in millions of dollars unless otherwise indicated)

	U.S. Multinational Companies		U.S. Affiliates of Foreign Firms
	Parent Companies	Foreign affiliates	
Number of firms	3,348	23,928	5,270
Employment (thousands)	21,377.3	10,028.0	5,562.3
Employee compensation	\$1,236,060	\$372,050	\$350,197
Gross product	\$2,215,800	\$824,336	\$514,957
Total assets	\$15,777,761	\$8,757,063	\$6,384,667
Sales	\$6,948,995	\$3,768,733	\$2,521,353
Taxes	\$153,487	\$161,253	\$49,223
R&D Expenditures	N.A.	N.A.	\$33,102

Source: *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2004 Estimates*; and *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 2004 Estimates*. Bureau of Economic Analysis, 2006.

Foreign-owned establishments, on average, are far outperforming their U.S.-owned counterparts. Although foreign-owned firms account for less than 4% of all U.S. manufacturing establishments, they have 14% more value added on average and 15% higher value of shipments than other manufacturers. The average plant size for foreign-owned firms is much larger — five times — than for U.S. firms, on average, in similar industries. This difference in plant size apparently rises from an absence of small plants among those that are foreign-owned. As a result of the larger plant scale and newer plant age, foreign-owned firms paid wages on average that were 14% higher than all U.S. manufacturing firms, had 40% higher productivity per worker, and 50% greater output per worker than the average of comparable U.S.-owned manufacturing plants. Foreign-owned firms also display higher capital intensity in a larger number of industries than all U.S. establishments.

Differences between foreign-owned firms and all U.S. firms should be viewed with some caution. First, the two groups of firms are not strictly comparable: the group of foreign-owned firms comprises a subset of all foreign firms, which includes primarily very large firms; the group of U.S. firms includes all firms, spanning a broader range of sizes. Secondly, the differences reflect a range of additional factors, including the prospect that foreign firms which invest in the United States likely are large firms with proven technologies or techniques they have successfully transferred to the United States. Small foreign ventures, experimenting with unproven

technologies, are unlikely to want the added risk of investing overseas. Foreign investors also tend to opt for larger scale and higher capital-intensity plants than the average U.S. firm to offset the risks inherent in investing abroad and to generate higher profits to make it economical to manage an operation far removed from the parent firm.

Most economists conclude that foreign investment benefits the host economy because such investment adds permanently to the capital stock of the economy and increases the total amount of capital in the economy. While these conclusions seem generally to be true, they probably should be tempered somewhat relative to foreign direct investment in the United States. The data in **Table 3** show the inflows and outflows of capital in the U.S. economy over the past eight years that are associated with direct investment. The data indicate that firms can raise funds in three different ways: they can borrow it from the parent company as an intercompany debt transfer; they can raise the funds in the domestic economy in the form of equity capital, or they can raise their funds internally from profits generated by the firm and used as reinvested earnings.

Table 3. U.S. Direct Investment Abroad and Foreign Direct Investment in the U.S. Economy, Annual Flows 1998-2005
(in billions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005	2006
U.S. direct investment abroad								
Capital	\$224.9	\$-59.2	\$142.3	\$154.5	\$149.9	\$244.1	\$9.1	\$228.3
Equity capital	98.9	78.0	60.9	42.7	35.5	81.4	39.7	25.7
Reinvested earnings	64.2	93.6	69.8	85.3	121.0	157.3	-11.2	202.1
Intercompany debt	61.8	-12.4	11.6	26.5	-6.6	5.4	-19.4	0.4
Foreign direct investment in the United States								
Capital	\$289.4	\$321.3	\$167.0	\$84.4	\$64.0	\$133.2	\$109.8	\$180.3
Equity capital	221.6	259.6	140.9	105.3	93.4	74.1	57.7	81.5
Reinvested earnings	4.1	-0.3	-33.9	1.6	14.5	55.6	58.9	101.6
Intercompany debt	63.8	61.9	60.0	-22.6	-44.0	3.5	-6.9	-2.9

Source: U.S. Department of Commerce.

The data in **Table 3** indicate that over the eight-year period 1999-2006, 8% of the funds foreign firms used to invest in U.S. businesses came from the foreign parent company in the form of intercompany debt. The rest of the funds foreign investors used to invest in U.S. businesses was raised in the United States, not imported from abroad. Equity capital raised in the U.S. capital markets accounted for 77% of the share of the funds foreign firms used to invest, with the rest, 15%, generated from the reinvested earnings of the foreign firms. In comparison, the overseas affiliates of U.S. parent firms raised the largest part of their funds — 72% — from the reinvested earnings of the affiliates, partly reflecting the older, more mature nature of the investments. Of the rest of the funds, 42% was raised through the equity capital markets in the host country, and 6% was raised through intercompany debt.

Supporters of foreign direct investment also highlight the number of jobs created by foreign investment in the economy. In the case of foreign direct investment in the U.S. economy, however, the employment picture is somewhat unclear. While foreign direct investment on the whole does support and contribute to existing employment in the economy, the particular nature of the investment makes it difficult to assess the full contribution of this investment to the overall employment picture. Foreign firms can invest in the U.S. economy in three ways: by adding to current investments; by establishing a new venture, termed, a “greenfield” investment; or by acquiring an existing U.S. business. The data in **Table 4** exclude additions to employment that can be accounted for by on-going foreign-owned firms and focus on U.S. businesses that are acquired or are newly established by foreign investors.

Table 4. U.S. Businesses Acquired or Established by Foreign Investors

(in millions of dollars, unless otherwise indicated)

	Total assets	U.S. business enterprises acquired				U.S. business enterprises established			
		Total assets	Sales	Number of empl.	Investment outlays	Total Assets	Sales	Number of empl.	Investment outlays
1998	\$274,349	\$218,483	\$147,434	603,385	\$182,357	\$55,866	\$17,471	21,199	\$32,899
1999	454,012	430,226	115,534	589,311	265,127	23,786	8,718	13,368	9,829
2000	482,021	463,142	153,525	748,952	322,703	18,879	7,204	21,068	12,926
2001	382,308	311,220	90,778	335,088	138,091	71,087	18,131	74,879	9,017
2002	105,516	92,800	51,945	211,679	43,442	12,716	3,735	6,808	11,077
2003	219,072	198,474	51,376	161,607	50,212	20,598	3,173	4,449	13,379
2004	308,638	252,481	60,592	199,227	72,738	56,127	6,744	12,366	13,481
2005	170,462	156,792	64,686	219,066	79,220	13,670	1,248	4,695	7,603

Source: McNeil, Lawrence R., Foreign Direct Investment in the United States: New Investment in 2005. *Survey of Current Business*, June 2006. p. 32.

The data in **Table 4** also indicate that during the 1998-2005 period, acquisitions of existing U.S. firms accounted for nearly 90% of the assets of the businesses that were either newly established or acquired by foreign investors, 95% of the increases in employment, 92 % of the sales, and 91% of the investment outlays. As a result, employment associated with acquisitions of established U.S. firms account for a large part of the total number of employees of foreign firms that currently are operating in the United States. It is likely that such acquisitions likely help to sustain the level of employment of the acquired firms, but it is difficult to estimate how much new employment is added to the economy as a result of the extensive role foreign acquisitions play in the economy. It also is unclear what long-term impact these acquisitions is having on employment among the acquired firms. In some cases, foreign firms may use their acquisitions as a springboard to expand their operations and, therefore, their employment in the United States, in other circumstances, they may use an acquisition to consolidate or to streamline other operations, which may result in reducing their level of employment.

As **Table 5** shows, acquisition activity is not limited to foreign firms, but is a well-established feature of the overall business climate in the United States. In terms of the number of acquisitions that were completed, 1998 stands out as the most active year, with over 10,000 deals completed. As the U.S. economy posted strong economic growth through the later 1990s and into the early 2000s, such acquisition activity remained strong among all three groups: U.S. firms acquiring U.S. firms; foreign firms acquiring U.S. firms and U.S. firms acquiring foreign firms. On average over the 10-year period, nearly 8,000 acquisitions were completed each year among the three types of investments. The share of these transactions accounted for by foreign acquisitions of U.S. firms grew by 50% over the 1998-2005 period, rising from 8% of all acquisition transactions in 1998 to slightly over 13% of all transactions in 2005.

Table 5. U.S. and Foreign Acquisition Activity, 1997-2006

Year	Total Acquisitions		U.S. Acquisitions of U.S. Companies		Foreign Acquisitions of U.S. Companies		U.S. Acquisitions of Foreign Companies	
	Number of Deals	\$ Billions	Number of Deals	\$ Billions	Number of Deals	\$ Billions	Number of Deals	\$ Billions
1997	8,479	\$563.0	6,317	\$606.3	775	\$84.9	1,387	\$80.3
1998	10,193	771.5	7,575	1,019.6	971	227.0	1,647	127.2
1999	9,173	1,373.8	6,449	1,005.1	1,148	264.0	1,576	153.8
2000	8,853	1,422.9	6,032	1,304.6	1,264	338.0	1,557	139.0
2001	6,296	1,781.6	4,269	838.3	923	204.3	1,104	113.2
2002	5,497	1,155.8	3,989	450.4	700	85.5	808	89.1
2003	6,169	625.0	4,539	352.8	750	82.0	880	90.7
2004	7,102	525.5	5,140	628.6	822	104.1	1,140	122.6
2005	7,600	855.3	5,463	733.9	977	112.7	1,160	150.3
2006	8,203	996.9	5,853	1,047.9	1,074	139.8	1,276	188.5

Source: *Mergers & Acquisitions*, February 2007. p. 69.

Another notable feature of the data is the way in which foreign acquisitions of U.S. firms and U.S. acquisitions of foreign firms seem to rise and fall in tandem. As the rate of U.S. economic growth slowed in the early 2000s, acquisition activity slowed not only in the United States, but for U.S. acquisitions abroad as well. **Figures 1 and 2** show the number of deals and the value of those deals for U.S. acquisitions of foreign firms and foreign acquisitions of U.S. firms, respectively. In both cases, the number of deals and the value of those deals dropped between 2000 and 2002 for both U.S. and foreign firms before activity rebounded after 2002. Such similarities in the acquisition activity of U.S. and foreign firms seem to be counter-intuitive in that those forces that draw U.S. firms to invest abroad should theoretically be separate from those factors that draw foreign firms to invest in the United States.

Figure 2. U.S. Acquisitions of Foreign Companies

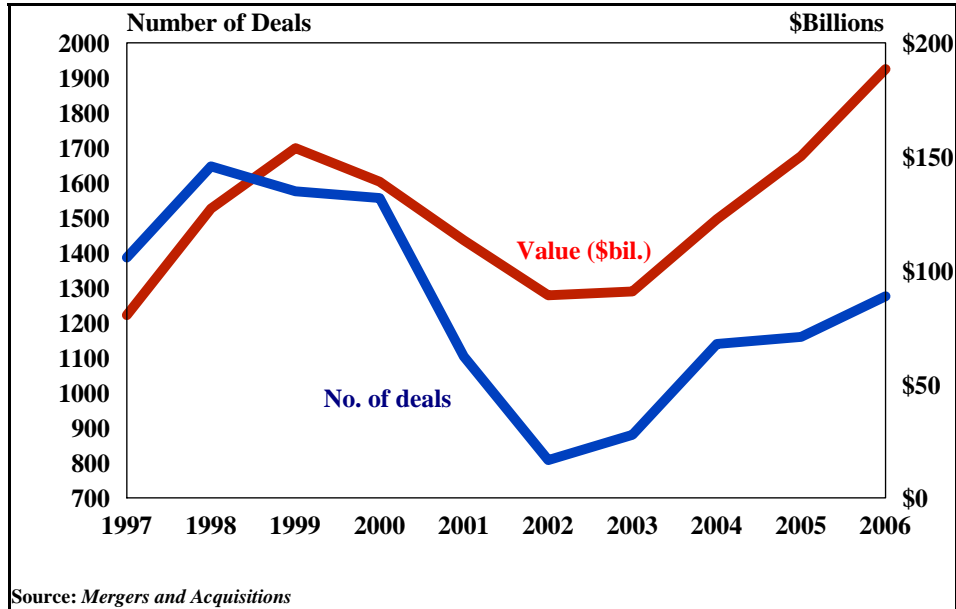
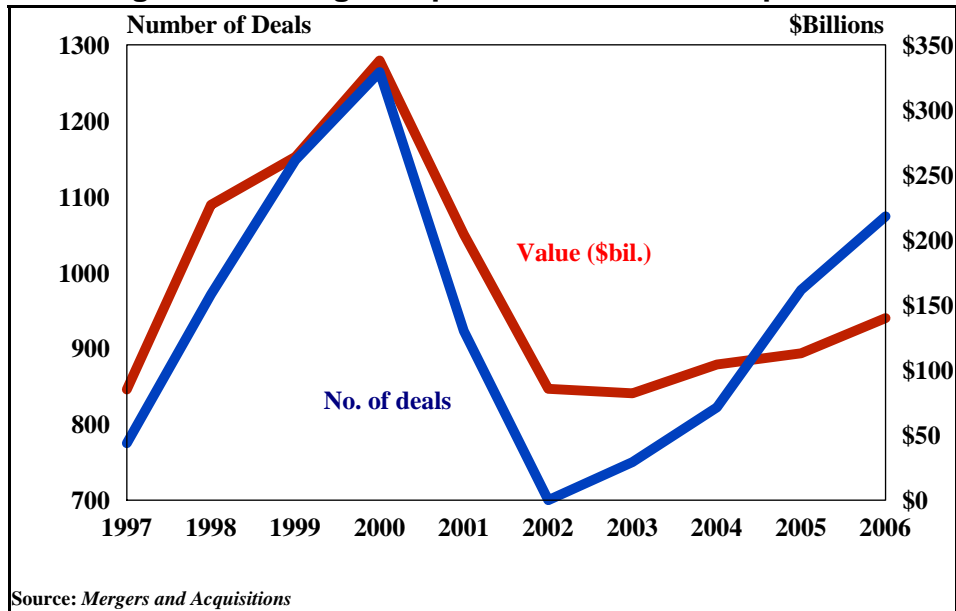


Figure 3. Foreign Acquisitions of U.S. Companies



In some respects, foreign investment in the United States and U.S. investment abroad should operate as substitutes, so that both U.S. and foreign firms would be expected to invest in the United States when the U.S. economic growth rate was strong relative to other advanced economies and both U.S. and foreign firms would be expected to invest elsewhere when the relative rate of U.S. economic growth was weak. Instead U.S. investment abroad is strong when foreign investment in the United States is strong and U.S. investment abroad is weak when foreign investment in the United States is weak. The two trends likely reflect the impact the U.S. economy has on the global economy and particularly on Western Europe, where much of the U.S. overseas investment and acquisition activity is concentrated. As

a result, when the rate of economic growth in the United States is strong, foreign firms are drawn to invest in U.S. businesses. In addition, the stronger rate of economic growth in the United States enhances the profit position of U.S. firms which encourages them to increase their investments both at home and abroad as U.S. economic activity also boosts economic performance in Western Europe and among other developed economies that have become increasingly linked with the U.S. economy.

Conclusions

The terrorist attacks of September 11, 2001, have affected the perception of many policymakers and elements of the public about the role and the risks of foreign investment in the economy. As a result, some Members of Congress are calling for changes in U.S. investment laws and U.S. investment policies that will increase the federal government's scrutiny over foreign investment in critical industries and in sectors essential to national security and to homeland security. In addition, Congress may broaden its oversight over the activities of federal agencies that are involved in administering U.S. direct investment policies. Economic studies generally conclude that the U.S. economy as a whole is benefitting from inward and outward direct investment. That is not to say that such investment does not bring costs as well as benefits. Indeed, some groups within the economy and some regions within the country likely benefit more than others. While dislocations likely are resolved eventually, they potentially can cause disruptions for some producers and some workers, especially those at the margins of the economy and struggling to remain competitive.

While Congress is grappling to sort out conflicting viewpoints and policies concerning the role and impact of foreign direct investment in the economy in a world of heightened security concerns, the recently announced *Invest in America* initiative stands out. The stated objective of the initiative is to promote the United States as a foreign investment location, which likely is aimed at assuaging foreign concerns about the course and direction of U.S. policies toward foreign direct investment. Although such a policy is not necessarily at odds with actions within Congress, it does seem to be a major shift in the traditional U.S. policy of neither helping nor hindering foreign direct investment. The initiative also raises questions concerning the cost of the initiative, how funds will be appropriated, and the role of congressional oversight. It is also unclear what role the initiative will have in coordinating the investment promotion activities of state and local governments that are accustomed to operating on their own and often compete against other localities for foreign investment commitments. In addition, while foreign direct investment does have positive net benefits for the economy as a whole, empirical research has not established that such benefits remain unambiguously positive when tax and financial incentives are offered as inducements.