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Responding to Chinese Direct Investment in the United States

A report prepared by the Princeton Task Force on Chinese Investment in the United States, a Junior Policy Task Force in the Woodrow Wilson School of Public and International Affairs at Princeton University

This report reflects the conclusions and recommendations of the Princeton Task Force on Chinese Investment in the United States, a four-month project aimed at developing strategic policy responses to increasing Chinese foreign direct investment (FDI) in the United States. Spearheaded by Professor Sophie Meunier, nine Princeton students at the Woodrow Wilson School of Public and International Affairs analyzed the extent and motivations of Chinese investment in the United States to inform policy approaches directed at Chinese FDI. The Task Force also investigated the precedent of Japanese investment in the 1980s, as well as the issues surrounding the U.S.-China bilateral investment treaty. The Princeton Task Force on Chinese Investment in the United States culminates with the release of this report along with a presentation in Washington, D.C., on December 6, 2013.

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I. Introduction

From the age of "made in China," the global economy is entering a new era of "owned by China." In places from Australia to Zimbabwe, in everything from automobiles to zinc, Chinese capital has flooded markets worldwide. Although the majority of Chinese investment in the United States has traditionally consisted of routine portfolio investment, often through the purchase of American debt, direct investment in the form of greenfield projects and mergers and acquisitions (M&As) is predicted to increase as China diversifies its massive capital reserves. Indeed, Chinese direct investment in the United States has already begun to take off: between 2009 and 2013, total Chinese FDI in the United States grew by nearly 600 percent, signaling the onset of exponential growth; in the first nine months of 2013 alone, Chinese FDI totaled a record $12.2 billion (Rhodium Group 2013). As this investment continues to grow, it seems inevitable that sensitive deals will come under the political crosshair, attracting negative attention and provoking popular backlash, especially if Chinese investors acquire treasured assets and national icons. How should the United States respond?

This question has motivated the inquiry of this Task Force. We have endeavored to gain a better understanding of the potential consequences of Chinese investment by studying past FDI in the United States, exploring the unique characteristics of Chinese FDI, and examining the targets of Chinese investors. It is the consensus of this Task Force that, all things considered, the United States stands to benefit from an increase in Chinese investment, but must proceed with due caution. From our analysis, we recommend a course of action that encourages FDI growth while mitigating domestic backlash.

China's Rise

To many throughout the world, it seems that the "post-American" era is already upon us: with unprecedented levels of economic growth, the world's largest population and standing military, and more honors students than total students in the United States, China appears poised to overtake America as the world's leading superpower. While economic malaise and gridlocked politics in the United States force Americans to question the effectiveness of their country's economic and political systems, Chinese firms are ramping up investment across the country, acquiring companies and undertaking greenfield projects from California to New York.

Perceptions of China as a global economic juggernaut, however, greatly exaggerate its investment footprint in the United States. As of 2013, China still accounts for less than 1 percent of America's FDI total stock and is responsible for the employment of approximately 70,000 Americans. But while China's investment in America remains marginal today, it will continue to grow as Chinese firms go abroad to gain resources, technology, brands, managerial know-how, and market access – all under the influence of an activist government eager to diversify China's holdings by sending Chinese enterprises overseas. Consequently, Chinese firms are projected to invest as much as $2 trillion worldwide by 2020.

To put Chinese FDI in perspective, Singapore, a country with less than 1 percent of China's population and annual output equal to only 2 percent of China's GDP, has 10 times China's accumulated FDI stock. European countries have been heavily investing in the United States for decades, yet congressmen are not currently calling for increased restrictions on FDI from Great Britain or France. Historical precedent suggests that FDI from even a sensitive country will gain mainstream acceptance as it roots itself in local communities and promotes economic growth. But might China, exceptional in so many regards, pose an unprecedented challenge?

What Makes China Different

Much of the concern voiced about Chinese FDI today echoes anti-Japanese rhetoric in the 1980s. There are several similarities between contemporary Chinese investment and Japanese investment 30 years ago: rapid growth, ownership of U.S. debt, fear of American decline, a ballooning trade deficit, and public anxiety. But China today is different from Japan in several important ways.

For one, a majority of Chinese investment overseas comes from state-owned enterprises (SOEs). For many multinational companies, the decision to invest in the United States is purely commercial. When the state owns a controlling interest in a fleet of multinational firms, however, it is conceivable that these companies are acting on strategic, rather than profit-maximizing, goals. Prominent American politicians have suggested that Chinese firms, on orders from the regime in Beijing, are bent on "buying up" America and pushing U.S. firms out of their own market in a bid for strategic dominance.

When viewed alongside China's status as a military rival of the United States, the issue takes on added heat. Unlike Japan, which has been an ally since 1945, the U.S.-China relationship has ranged from outright antagonism to more muted competition. In light of the possibility of future conflict, American policymakers are increasingly concerned about the motives driving Chinese FDI and about what leverage these investments could provide a rival government.

BALANCING SCREENING AND PROMOTION

Although the volume and track record of Chinese investment in the United States does not warrant fears of China "taking over," the public remains wary. Capitalizing on this unease, a determined senator or lobbyist can block even an economically beneficial deal regardless of the findings of the Committee on Foreign Investment in the United States (CFIUS). The increase in Chinese FDI in the United States should be addressed in a systematic and deliberate fashion in order to prevent party politics and special interest groups from dominating the political discourse.

Given the sluggish state of the American economy and the positive effects of FDI – including the potential for increased domestic employment and economic growth – America should strive to attract as much Chinese investment as is consistent with its national security. Otherwise, Chinese firms will take their capital to emerging economies such as Brazil or India, developed regions like the European Union (EU) – or even to American enemies such as Iran or North Korea. The heated competition between countries for Chinese investment only exacerbates this capital deflection from the United States. At the same time, policymakers should guard against political or economic backlash arising from the suspicion that they have struck a Faustian bargain with Beijing by accepting money at the expense of U.S. principles.

Presently, U.S. authorities should quickly and decisively combat the instinctive backlash against Chinese investment in order to advance the Obama administration's goal of attracting more foreign investment. If domestic fear-mongering and scapegoating escalate, congressional leaders might tighten the U.S. investment review process, thereby restricting the flow of capital and making America less open to investment. At the same time, however, American authorities must acknowledge that Chinese FDI is to a large extent an unprecedented phenomenon. The two pillars of FDI policy, investment promotion and investment screening, should not impede, but rather complement, one another.

This report discusses nine aspects of Chinese FDI in the United States. These are:

- An examination of the unique characteristics of Chinese investment in the United States;
- A look back at Japanese FDI in the 1980s as a historical precedent for Chinese investment;
- An analysis of the modes of entry of Chinese firms, greenfield versus M&A;
- An examination of the phenomenon of reverse technology flows;
- An evaluation of CFIUS, the U.S. investment review process;
- A cross-country comparison of inbound FDI regulatory regimes;
- An overview of investment promotion in the United States and overseas;
- A look at California, a state host to robust Chinese investment, as a model for U.S. investment promotion efforts; and
- An assessment of the prospects of a U.S.-China bilateral investment treaty (BIT).

The report concludes with seven policy recommendations drawn from the above analysis.

II. Characteristics of Chinese Investment

Chinese FDI in the United States often comes with a host of security, economic, and political considerations not usually associated with investment from other countries. Overall, Chinese investors do not act in a sufficiently different manner from other investors to warrant an idiosyncratic policy response. Seeking to maximize profit, they behave like most other investors once on the ground. Nevertheless, Chinese firms differ most from firms from other countries in the unique national security threat that a few of them may pose, as well as in some of their economic characteristics and motivations What makes Chinese FDI different, however, is the unique perception that the American public holds about it.

Unique Security Concerns

China's "strategic competition" with the United States and the Chinese government's opaque, close relationship with certain companies raise legitimate concerns over Chinese FDI.

1. **Telecommunications Infrastructure**

   U.S. policymakers on the Permanent Select Committee on Intelligence and CFIUS correctly identified Chinese telecom companies – particularly Huawei and ZTE – as threatening because of their suspicious relationship with the Chinese government's intelligence agencies. These firms place America at risk of spying and cyber attacks.

2. **Proximity to U.S. security installations**

   Chinese firms such as Sany and CNOOC have attempted to invest in locations close to U.S. military facilities. Chinese spying is threatening to U.S. security and insufficiently guarded against by CFIUS jurisdiction because greenfield investments are not a covered transaction, yet pose identical spying risks.

Unique Economic Characteristics and Motivations

Whether private corporations or state-owned enterprises, Chinese firms differ most from traditional investors in their economic behaviors and motivations.

***Private firms*:** Privately owned Chinese companies account for 70 percent of FDI by number of deals. Although private, these firms' motivations for investment often differ from those of traditional investors.

1. **Acquiring Brands**

   In a 2013 survey, 94 percent of Americans could not identify a single Chinese brand and a third would not buy a product from a Chinese company. Many Chinese firms have found it easier to purchase a global reputation than build one from scratch. Buying internationally well-regarded but financially-struggling companies has been many Chinese companies' strategy in building multinational empires.

2. **Reverse Technology Flows**

   In the traditional FDI model, industrialized nations invest in developing countries, bringing over technology ranging from technical expertise to managerial know-how. Chinese investment in the United States illustrates the opposite behavior, whereby lower-tech firms buy higher-tech companies for the purpose of acquiring technology.

***State-Owned Enterprises (SOEs)*:** China's SOEs have conducted 65 percent of FDI in the United States by value and at first appear to be threatening entities. However, SOEs entering U.S. markets still face competition, are subject to internal regulations, and behave more like free market actors than China's professed "socialism with Chinese characteristics" would imply. The United States has a long, successful history of welcoming FDI and should not adopt protectionist measures when faced with these atypical Chinese firms.

1. **Macroeconomic Imbalances**

   Government policies that suppress the Chinese *renminbi* coupled with restrictions on private investment have led to an accumulation of foreign exchange reserves in

China. Government and private entities alike now seek to invest this money abroad in high-yield, low-risk assets. The Chinese state has already taken such steps as proclaiming the "Going Out" policy and creating sovereign wealth funds that now control 35 percent of the wealth in the world's top 5 SWFs.

2. **Structure of SOEs**

   China's SOEs are not structured in a market-oriented way. The State Owned Assets Supervision and Administration Commission (SASAC) selects the SOEs top executives, approves certain transactions, and drafts laws governing SOEs. Executives are regularly recruited into the Communist Party Leadership and are often judged by the size and technological capabilities of their SOEs rather than profit-maximizing metrics. Many SOEs receive generous state subsidies, have opaque governance structures with low financial disclosure, are rife with corruption, have demonstrated that they invest inefficiently in R&D and Chinese markets such as real estate, and are associated with the legacy of Chinese state socialism. No matter their nationality, SOEs are generally regarded as inefficient, stagnant, and oversized. However, when regulating businesses, U.S. policymakers should focus on behaviors rather than structure because acquiring sufficient information to regulate based on an SOE's structure would be impractical and outputs matter most. Despite their potential for government-directed action, however, Chinese SOEs in the United States have not behaved differently from market actors. There has also been a push for profit maximization from both the Chinese public and government policymakers, as well as ongoing SOE reform. Imposing new economic regulations now would be premature and risk enacting exactly what they seek to avoid – government meddling in the economy. Before taking action, policymakers should wait and see if SOEs behave differently enough to pose a threat.

3. **Resource-Seeking Behaviors**

   Chinese SOEs have heavily invested in securing access to raw material inputs. As of 2009, 19 percent of Chinese FDI stock in the United States was in natural resources. Although these SOE actions follow Chinese government policy, they can be understood as Chinese firms attempting to achieve vertical integration. China's consumption of raw materials has been growing, and raw material price increases have been larger than price increases in the finished product. When Chinese firms invest in resources, they protect themselves from price shocks and capture profits that would have otherwise gone to raw material suppliers – both behaviors present in functioning markets. This behavior presents no threat outside of traditional security concerns over monopoly control or resource denial.

UNIQUE POLITICAL PERCEPTIONS

The thought of China "taking over" the United States continues to evoke unease in the American public's mind. A mix of its recent history, formally socialist economic system, rising military capabilities, record on human rights, non-Western culture, and rising international status has contributed to the tendency to treat Chinese investment as decidedly "other." Politicians on the national stage have capitalized on these feelings, antagonizing Chinese investment to score political points. Legitimate concerns over U.S. national and economic security aside, the repeated political theater surrounding Chinese FDI sends the wrong message to investors in China – that their money is unwelcome here. A large part of what makes Chinese FDI unique is that Americans think of it as unique. Dealing with Chinese FDI will have to involve changing what the public thinks of China.

III. The Japanese Antecedent

The backlash that Chinese FDI faces today is very reminiscent of the experience of Japanese firms in the 1980s. This memo assesses how U. S. policymakers can use the Japanese antecedent to: 1) learn how to respond to the influx of Chinese FDI that has developed in recent years and 2) examine how looking back to the Japanese example informs Chinese policymakers and investors in dealing with the United States.

In the first nine months of 2013 alone, Chinese firms have invested $12.2 billion on 55 greenfield projects and acquisitions in the U.S. Similarly, Japanese FDI increased from $1 billion in 1980 to over $20 billion annually by 1990. This extreme increase in FDI coupled with the high-profile purchases of Rockefeller Center by Japanese firm Mitsubishi and of Columbia Pictures by Sony in 1989 led to a public backlash similar to that faced today by Chinese investment. This historical example provides useful insight into the motivations behind Chinese actions regarding FDI and will help inform policymakers' decisions in the future.

Similarities between Japanese FDI in the 1980s and Chinese FDI today

1. **Undervalued Currency**

   The United States criticized Japan for the undervalued Yen relative to the dollar in the 1980s, which resulted in the Japanese trade surplus. Similarly, one of the main criticisms against China today is China's manipulation of the RMB.

2. **Trade Imbalance**

   The U.S. trade imbalance in goods with Japan three decades ago (nearly $55 billion) tainted U.S. policymakers' and the private sector's opinion towards Japanese investment. Factoring in inflation, the trade deficit would be about $120 billion in 2013. This year alone, the trade deficit between the United States and China has exceeded $238 billion. U.S. public attitudes towards Chinese investment mirror attitudes towards Japanese investment in the 1980s.

3. **Economic Power**

   Japan's economy grew 10 percent in the 1960s, 5 percent in the 1970s and 4 percent in the 1980s, prompting the fear in the United States that Japan would soon pose an economic threat. China's GDP has had an annual growth rate of around 10 percent since 1990, which has created a similar response.

Differences between Japanese FDI in the 1980s and Chinese FDI today

1. **Security Relationship**

   Japan in the 1980s was one of America's greatest security allies in East Asia after the Treaty of Mutual Cooperation and Security between the two countries was signed in 1960. China, in contrast, is considered by most to be a strategic adversary to the United States. It has strong ties to countries with which the United States has no diplomatic relations, including North Korea and Iran. China is also committed to challenging the United States in its bloc of influence in the Pacific.

2. **Technology Flows**

   In the 1980s, Japanese companies in the automobile and other technological industries would have made positive technology transfers from Japan to the United States possible. However, the flow of technology between China and the United States would be much more one-sided to China's advantage.

3. **State Control**

   Despite U.S. concerns about Japanese investment, Japan was still a capitalist country. Meanwhile, China is an authoritarian state; the line between the state and the private sector is unclear.

Lessons from the Japanese Precedent

Although there was a significant backlash in response to the high levels of Japanese FDI in the 1980s, this criticism dwindled by the 1990s due to the bursting of Japan's real estate bubble. There

was no longer a perceived threat of Japan's growing economy. Today, Japanese investment in the United States is second only to that of the United Kingdom. Moreover, the American economy has benefited from Japanese investment. By the mid 2000s, Japanese companies accounted for over 650,000 jobs in the United States Despite the premature concerns of policymakers with respect to Japanese FDI, many Japanese firms have made broad contributions to the U.S. economy. Japanese brands such as Toyota were able to fully integrate themselves in the U.S. economy at the local level by the late 1990s. Today, Toyota employs 365,000 Americans in the United States and spends $1 million every hour on research and development. It boasts a commitment of nearly $700 million in philanthropic contributions and it recently created 2,000 new jobs at its newest Mississippi plant. As this Japanese example suggests, Chinese FDI can similarly positively impact the U.S. economy.

China also stands to learn much from the Japanese precedent. Similar to the Japanese example, Chinese firms will face outright resistance or wariness at the national level in the United States. However, the Japanese antecedent suggests that concerns over a new foreign direct investor will eventually decrease and Chinese firms will be able to eventually assimilate in the corporate world in the United States. It has also become increasingly clear that China has been learning from the Japanese example in order to invest in the United States without facing public backlash. They are learning to avoid high profile acquisitions. For instance, Chinese auto companies that have been investing in U.S. markets have attentively circumvented prominent media coverage to avoid the public opposition experienced by Toyota and Honda in the 1980s. Shanghai Automotive Industries, the biggest automaker in China, avoided media publicity, which is described as rare in the automobile industry, when they opened offices in Detroit.

IV. Greenfield versus Mergers & Acquisitions

In the past few years, the United States has seen tremendous growth in the total amount of inward FDI from China both in the form of greenfields projects and mergers and acquisitions (M&As). Since 2000, Chinese firms have spent a record of $35.8 billion on greenfield projects and M&As in the United States. This memo examines each type of FDI to help answer whether or not the United States should treat greenfield investments differently from M&As when reviewing FDI policies.

Greenfields and Mergers & Acquisitions

Chinese firms can create a subsidiary in the United States by building a company from the ground up through a greenfield project or by acquiring an existing firm through a M&A. While greenfield investments create new companies, M&As result in an adjustment of a firm's current presence in a market. As an entry mode of Chinese capital, the majority of Chinese FDI in the United States by volume has been greenfield projects setting up distribution channels to facilitate trade and sales offices. While total Chinese FDI in America in the form of greenfield has been high, M&As are growing rapidly and recently surpassed greenfield projects.

Between 2000 and 2012, 620 deals between China and the United States have been recorded. Out of those 436 were greenfield projects while only 184 were M&As, as reported by the Rhodium Group. However, the numbers in value tell a different story. While the total estimated value amounts to $22.7 billion, only $3.3 billion comes from greenfield projects while $19.4 billion, or 85 percent of the total, comes from M&As. Because of the higher price tags on most major M&A purchases, acquisitions tend to come at a high value than greenfields. This is why the total value of M&As is higher despite fewer deals.

M&As have been the preferred mode of entry to America because of a diverse and changing set of investment motives. A survey conducted by the Rhodium Group in 2005 pointed to three main motives for Chinese FDI. Chinese investors see market-seeking motives as 56 percent of their motivation to invest, while obtaining technology and brands stood at 16 percent, and securing resources at 20 percent. Thus with the majority of Chinese investors motivated by market-seeking incentives, M&As tend to be the preferred method of investing, since Chi M&As are a more reliable source of capturing the market with the security of pre-established firms.

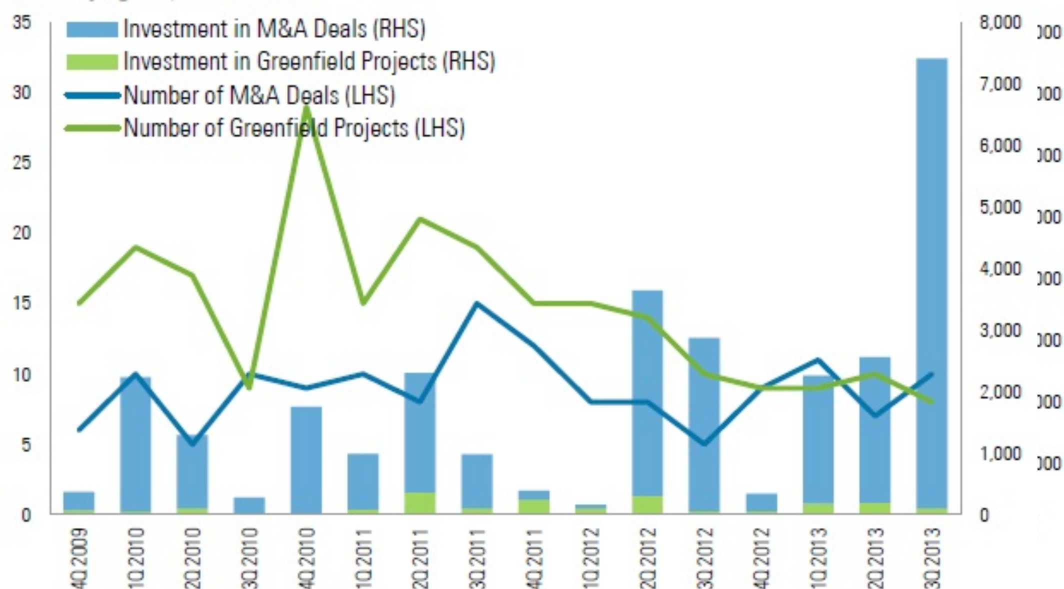


Figure I: Chinese Direct Investment in the United States, Q4 2009 – Q3 2013*

Source: Rhodium Group. *Numbers are preliminary and subject to adjustment. A detailed explanation of sources and methodology can be found at: http://rhg.com/interactive/china-investment-monitor

Comparison of Benefits and Costs

Both types of investments have their benefits and challenges for the host country. Through an M&A, a company can expand its internal organization through external market trading. However, greenfield projects are often favored by host countries over M&As because they build a company from the ground up, and in order to meet new production capacity, the company must hire workers, obtain land purchases, acquire means of production from the market, etc. In general, Americans tend to view greenfield investments as a less problematic form of entry because they create new jobs and tax revenues and do not require a change in ownership

Through M&As, the acquiring company benefits from obtaining the acquired firm's technology, patents, and professional personnel. In addition, it reduces the risk of failure and allows the company to better keep up with the market. For instance, Lenovo, a Chinese technology company, acquired IBM's personal computer business in 2005. This acquisition gave Lenovo greater access to foreign markets in addition to improving its branding and technology, ultimately making Lenovo the third largest computer maker in the world. For the same reasons Chinese investors consider M&As attractive, Americans firms often view M&As as a bigger threat than greenfields. M&As increase the likelihood of reverse technology flows and layoff of employees. However, this should not suggest greenfield projects do not have drawbacks as well. Greenfields sometimes create tension in employment practices. Additionally, local communities tend to argue that the entrance of greenfield projects creates excess capacity in an industry, resulting in a lack of skilled workers in certain trades and the potential closure of US factories.

Controversies

While most high profile cases have been over controversial acquisitions in politically sensitive industries, Chinese investors have been mostly cautious in their purchases. However, there is still growing concern in the United States about the fact that greenfield investments are not covered by the CFIUS review process. It is important to note that the national security concerns presented by M&A investments, like spying on U.S. security installations and tapping into telecommunication networks, are still relevant threats even with regard to greenfields. In 2012, CFIUS rejected the acquisition of wind farm assets in Oregon by the Chinese firm Ralls, on the grounds that they were too close to a nearby U.S. Navy facility. However, had the deal been presented as a greenfield project, in which a Chinese investor would erect a wholly new firm in the same location, CFIUS would not have had jurisdiction over the deal. Thus many critics fear that Chinese investors will use greenfield projects as a way of sidestepping U.S. protectionism. Since many critics believe that national security risk takes priority over the nature of the transaction, some have suggested that greenfields should be covered under CFIUS jurisdiction.

V. Reverse Technology Flows?

Traditionally, FDI has offered a multitude of benefits for the host country, one of which is technology spillover. However, with the unique case of China – a developing nation investing in a developed nation – a reverse technology spillover seems to occur. For developing nations, a main motivation for OFDI is precisely to harness R&D technology resources and import managerial talent back into the investing nation. But does this reverse flow significantly disadvantage the host country? The threat of reverse technology spillovers from the United States into China has become highly politicized, especially exacerbated by China's sustained reverse engineering patterns, intellectual property (IP) theft, and fear that China will exploit acquired technology by propagating it through unregulated domestic markets and also across borders. Though reverse technology spillovers involve legally acquired IP, they carry the stigma of "theft" in the eyes of the American public.

Existence of Reverse Technology Flows

Empirical studies have mapped a positive correlation of between China's OFDI growth rate and the nation's total factor productivity growth as well as to the number of patents licensed and patent applications over the past two decades. These relationships suggest that OFDI has a direct impact on the increase of technological growth in China. Science Research Parks have flourished to promote absorption of these technologies around the headquarters of companies with successful foreign acquisitions like Haier and Lenovo. We conclude that reverse technology spillovers do occur, but also note that China actively pursues FDI for the express purpose of harnessing these spillovers to foster domestic innovation, allowing it to integrate into Western business standards.

Innovation as an Explanation for Reverse Technology Flows

To understand the impact of reverse technology flows, we must discuss the motives of Chinese companies pursuing technology. The following show how *reverse technology spillovers from Chinese OFDI act as means for Chinese domestic innovation*:

1. **Failure of Internal Innovation**

   China has been trying to achieve efficient domestic innovation for the past decade. But despite drafting policies in the 5-Year Plans to reinvigorate "indigenous innovation," churning out patents, and becoming the second biggest investor in domestic R&D, China has yet to see effective innovation due to cultural and political barriers preventing entrepreneurship and the lack of managerial talent. But by following the success of nations like Japan and Taiwan in their innovation through FDI, China has begun to seek external methods like FDI as a solution to generate domestic innovation.

2. **The Choice of FDI**

   When China is interested solely in technology, it purchases IP directly. But the choice of FDI reveals its aim to acquire something more: R&D resources, management, innovative culture, and international market expertise. Thus, Chinese companies often prefer full acquisitions to joint ventures and mergers, fearing foreign firms' reluctance to transfer core competency to Chinese counterparts.

3. **Effective Reception**

   Core Science Research Parks have risen around the Chinese headquarters of these investing companies to powerfully increase the region's absorptive capacities, building national networks and alliances with local Chinese universities to proliferate its advantages for further innovation in these industries.

4. **Commercial Innovation**

   Unlike traditional Western companies that improve through research and development, Chinese companies have historically improved their products and business methods by actively participating in the market and adapting based on consumer response. They

naturally seek external investments to participate directly in the world market and innovate through the global commercial opportunities it provides.

5. **Adaptation to Western Business Culture**

   Chinese companies have shown a desire to learn and adapt to Western business culture in order to succeed in the international market. There have been initiatives to bring Western managers into the headquarters of Chinese companies and seat non-Chinese members on executive boards in an attempt to adopt new business practices to stimulate entrepreneurial culture within Chinese companies.

DISADVANTAGES

1. **Market Competition**

   Chinese innovation could be disadvantageous for America as it strives to maintain a competitive edge in the world market. In the short-term, this may provoke fear of China's rise and disdain for America's contribution to its success by permitting reverse technology flows and Chinese innovation. Looking at the long-term picture, however, the benefits seem to outweigh the perceived disadvantages.

ADVANTAGES

1. **International Standards**

   That Chinese FDI seeks innovation to keep up with Western business standards should quell fears of China attempting to circumvent law through reverse technology spillovers. In fact, innovation from reverse technology flows can benefit the international regime at large. As Chinese companies import knowledge from foreign companies and merge Western culture into their local headquarters, these major companies will be influenced by human rights, labor rights, environmental protection and other customary international regulations. Because the most effective method of innovation for China has come from commercialization, by altering the cultural fabric of China's most powerful and influential companies through reverse technology flows, China's OFDI contributes greatly to its alignment with international standards. By permitting FDI and reverse technology flows, America encourages Chinese companies to innovate within the bounds of U.S. regulatory norms.

2. **Avenues for Collaboration**

   Furthermore, by building business relationships and accountability through FDI, America opens important avenues for collaboration. Innovation is dynamic: we cannot expect the innovative capacity of China will stay stagnant. Especially with its current trends in OFDI, China will see efficient and effective innovation and growth within the next decade. As in the success of Lenovo, there exist potential synergies between American and Chinese companies that can revolutionize an industry. Moreover, increased investment in America implies that China will have an incentive to promote the American economy. With this in mind, it is important to encourage FDI from China, allowing the nation to adapt to and become comfortable with American business culture and thus keep an open door to seek potential collaboration in the present day and in the future.

VI. Evaluating CFIUS

While the particularity of Chinese investment may warrant special scrutiny in some cases, there is potential for missed investment opportunities because of misperceptions in China about the CFIUS screening process. There is a particular lack of clarity surrounding the definition of "national security" as it pertains to the review process. As a result, it is often difficult for Chinese investors to determine what elements of an investment may threaten U.S. security.

Confusion and uncertainty about the review process also extend to members of Congress. Congress has on several occasions felt compelled to intervene in the CFIUS process rather than take a hands-off approach, which has promoted a hostile political climate that is perceived as unwelcoming to foreign investors. The proposed 2005 CNOOC-Unocal deal, the 2006 Dubai Ports World deal, and more recently the acquisition of Smithfield Foods by Chinese firm Shuanghui, each prompted organized Congressional resistance. Commerce Department analysts estimate that as a result of the unraveling of the Dubai Ports World deal and America's hostile political climate, the United States lost over $1 billion in foreign investment from the United Arab Emirates in 2006 alone. Each instance of Congressional resistance was motivated by a lack of understanding about the screening process and a corresponding lack of confidence in CFIUS' ability to protect national security interests.

The result is a negative feedback loop, in which foreign investors are already hesitant to engage the process; they observe the America's hostile political climate for foreign investment, which increases their apprehension to invest in the United States This uncertainty is likely to deter Chinese investors, who may seek to invest in countries where the review process seems relatively less arbitrary, and in some cases, discriminatory. The United States may rightly want to be cautious about Chinese investment, but it should also present itself as "open for business" and not risk missing out on legitimate opportunities for investment.

Exon-Florio, FINSA, and "National Security"

FINSA defines "national security" to include "those issues relating to 'homeland security,' including its application to critical infrastructure." The terms "homeland security" and "critical infrastructure" are vaguely defined in the Defense Production Act of 1950, as amended. "Homeland security" is defined to include efforts to prevent terrorist attacks and to aid in the recovery of terrorist attacks perpetrated upon the United States. "Critical infrastructure" is defined as "any systems and assets, . . . so vital to the United States that the degradation or destruction of such systems and assets would have a debilitating impact on national security." This definition is extended to include economic security.

These definitions indicate that the majority of CFIUS reviews should concern investment in the defense industrial base, but the Committee has reviewed investment in other sectors, including technology, telecommunications, energy and natural resources, manufacturing, and transportation. The vagueness with which "national security" is defined in Exon-Florio and FINSA is justified primarily because a concrete definition would prevent the President from interpreting these concerns broadly; this authority is necessary to provide the president flexibility in protecting national security. The absence of clear guidelines makes it difficult for involved parties to make sense of CFIUS decisions and anticipate the outcome of a potential review.

Mandatory Investigation of Foreign-Government Controlled Transactions

FINSA provides a provision for foreign government-controlled transactions, mandating review of these transactions unless the Secretary or Deputy Secretary of the Treasury and the Lead Agency determine that the transaction does not present a national security threat. Roughly 90 percent of Chinese outbound investment by volume has been directed by SOEs, and though this number is gradually decreasing, it is likely that a disproportionate amount of transactions that are reviewed by CFIUS will be Chinese as a result of

the high proportion of SOEs investing abroad. This runs the risk of being interpreted as discriminatory; it should be made clear to Chinese investors that regulatory law mandates the review of SOE-directed transactions.

Troubled Transactions and Lost Opportunity for Investment

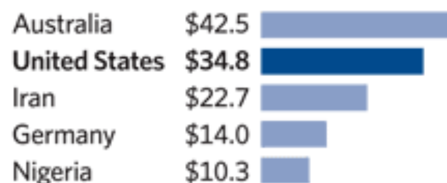
Through January 2013, the United States lost $34.8 billion in “troubled transactions” with China. Troubled transactions are those that were rejected by the host country, withdrawn prior to or during review, suffered sizable financial losses or collapsed due to investor error. If these transactions had not failed, the total volume of inbound FDI in the United States through January would have been nearly double what it was.

Some of these transactions failed for obvious reasons, like the Ralls Corporation investment in Oregon wind farms in the vicinity of a U.S. Navy training facility. However, several transactions failed for less obvious or compelling reasons, like the Dubai Ports World deal or the investment in Steel Development by Chinese firm Anshan Iron and Steel Group.

Without the provision of a set of clear, non-binding guidelines, the United States will miss out on opportunities for legitimate and non-threatening investment. Low confidence in the screening process will continue to be an issue. The CFIUS screening process has the potential to be made clearer without weakening or narrowing the scope of CFIUS; this enhanced clarity will help to mitigate instances in which legitimate investment in the United States fails, and will present America as a welcoming and attractive destination for foreign investment.

Troubled Transactions with China: Top Five Nations

IN BILLIONS OF DOLLARS



Source: The Heritage Foundation, China Global Investment Tracker dataset, updated January 2013, https://thf_media.s3.amazonaws.com/2013/xls/China-Global-Investment-Tracker2013.xls.

VII. Cross-Country Comparison of FDI Regulatory Regimes

The experiences of FDI screening mechanisms abroad suggest that the U.S. government can increase public confidence and investor certainty in the CFIUS review process by further clarifying the term "national security" and, if the need arises, adopting an SOE behavioral test.

The Problem

Despite widespread acceptance that inbound FDI (IFDI) confers great benefits to the American economy, congressional and public opinion have highlighted concerns about growing Chinese FDI into the U.S, including ownership of assets critical to national security and potentially market-distorting behaviour by state-owned enterprises (SOEs). Politicization of Chinese OFDI conveys a lack of congressional and public confidence in the existing regulatory framework to address these concerns. The high political cost incurred by Chinese investors deters FDI and transfers decision-making away from regulatory experts, shifting it instead towards vested interests that invoke public fears of a Chinese takeover. The need to increase regulatory coherence is particularly acute given that countries abroad, especially in the EU, are attracting Chinese capital more successfully and consistently.

The Aim

A coherent and rationalized FDI regulatory framework would restore the confidence of: (1) the public by appropriately accounting for their concerns and (2) foreign investors by reducing uncertainty through signalling clear requirements. Such a framework would be mutually beneficial by ensuring that the "right" investment is not politically deterred and is accepted. Regulatory regimes abroad suggest alternative approaches to achieve this goal.

Cross-Country Overview of Inbound FDI Screening

Canada and Australia, two relatively resource-rich yet market-oriented economies, have full screening processes for all investments over a certain threshold. Decisions are based on net national benefit in both countries and on impacts to local culture in Canada. As recent innovations, both countries have adopted national security reviews, and have issued guidelines for reviewing potentially market-distorting SOE investment behavior. Australia and Canada may have strict formal expectations for investors, but they continue to enjoy the highest levels of inbound Chinese FDI, and acquisitions are blocked very rarely.

France only reviews foreign investments in eleven sectors that have been defined as critical to national security under the 2005 "economic patriotism" decree. The limited nature of this positive list is reflected by France's low OECD FDI Restrictiveness Score.

Hungary and the United Kingdom do not have screening processes. The United Kingdom reserves the right to block acquisitions based on national security concerns at any stage. Hungary requires minimal notification on investments into the insurance and financial sectors and limits foreign

Country	OECD FDI Restrictive-ness Score	Favourable Perceptions of China (% of pop.)	Chinese FDI Inflow '09-'11 Avg (10^{-8}% of GDP)	Scope of Screening	Screening Criteria	Other important barriers to IFDI
United States	0.089	37%	0.50%	Voluntary notification	National security	
Australia	0.128	58%	25.8%	All over threshold	National interest test (incl national security)	
Canada	0.163	43%	75.6%	All over threshold	National interest test; cultural protection	National Security test
France	0.045	42%	0.3%	Critical sectors only	National security	
Hungary	0.049		-1.5%	No screening	None	Notifications for insurance and financial sector
United Kingdom	0.061	48%	0.5%	No screening	None	National security veto

Source: OECD, World Bank, Statistics Canada, Pew Research Center

ownership of land. However, both economies pride themselves on openness and have minimized barriers to entry.

AREAS FOR REGULATORY INNOVATION

1. National Security

Country	Experience with Huawei
Australia	Huawei has been banned form accessing the national broadband network.
Canada	Huawei has received awards for its investment into mobile networks and R&D, but investment into critical national infrastructure (CNI) that uses Huawei equipment has been blocked.
France	Telecom operators were ordered to dismantle Huawei CNI equipment.
Hungary	Huawei has established its center for European logistics in Hungary
United Kingdom	The United Kingdom has been explicitly open to investment from Huawei, but a Huawei cyber-research cell has been reviewed

All jurisdictions with national security reviews (the United States, Canada, Australia) have kept definitions of "national security" broad. Although such an approach is prudent, widely varying responses to common concerns, such as Huawei, suggests a degree of irrationality in ruling, particularly given the three countries, as members of Five Eyes, receive similar intelligence on risks. Tying the definition of "national security" to critical national infrastructure (CNI) and defence procurement would clarify CFIUS' mandate to both the public and investors. However, as the blocked Lenovo bid for Blackberry in Canada or the Ralls case suggest, legitimate concerns for national security may extend beyond CNI and defense, and a statutory limitation on "national security" in all cases, as in France, may be harmfully limiting. Publishing *non-exhaustive, non-binding, non-statutory clarifications* of the definition of national security should successfully increase certainty without limiting CFIUS' purview. In short, expectations of investors should be clear, not implicit. We commend the progress that has resulted from the Foreign Investment and National Security Act of 2007 (FINSA), namely: clarifications of "national security"; a presumption of sensitivity for CNI; and the 2008 release of "Guidance Concerning the National Security Review" (Fed. Reg. 74567). However, existing clarifications of "national security" have served to expand the definition rather than truly clarify it. In particular, statutory inclusion of "energy assets" to the CNI categorization is disconcertedly broad and hints at economic, rather than national, security. Moreover, FINSA's emphasis on the identity and intent of the investor in risk assessment also allows broad discretion for potentially arbitrary or discriminatory ruling.

2. SOE Discipline

Australia, followed by Canada, adopted a "behavioral conditionality" policy whereby SOEs are evaluated for market-conforming behavior in the domestic market. This behavior is defined roughly as adherence to common codes of business practice and operational independence from the home government. SOE investors can be required to list shares on a local stock exchange or establish independent local management. A behavioral approach avoids sweeping generalizations about SOEs, like the EU single-entity theory, yet reduces the burden of regulators to evaluate SOEs on a case-by-case basis. Unlike Britain, U.S. antitrust fears over Chinese investment have been pronounced and Australian innovations could allow the U.S. regulatory framework to account for these concerns. Given that SOEs are not subject to domestic market constraints, it is reasonable that antitrust regulators would not treat foreign SOEs under the national treatment principle. The economic, rather than national security, mandate inherent in an SOE behavioral test may seem at odds with the American free-market ethic, but if American domestic markets are significantly and adversely affected by SOE practices, Congress may want to consider this kind of SOE discipline mechanism in the future.

VIII. Investment Promotion in the United States

The United States can more effectively promote Chinese FDI. Although FDI inflows from China into the United States are growing, the European Union (EU) has outpaced the United States in this area. Major differences in promotion strategy are likely part of the reason why these regions have recently experienced different degrees of success in attracting Chinese FDI, as the literature suggests that stronger promotion results in higher levels of FDI flows.

Current State of U.S. Investment Promotion

Three main issues exist with America's current efforts: information gaps, an unfriendly environment, and a "race to the bottom."

1. Information Gaps

In Theory: Chinese investors begin at a major disadvantage when trying to penetrate Western markets. They have little understanding of labor and business regulations in this part of the world. Because of how different business conduct and regulation is in China, potential investors need help entering the U.S. market; they need to be told what is commonly accepted practice and how to initiate an investment. The investment promotion agency (IPA) of the country receiving Chinese investment should take charge of this job and help guide investors through the complicated process of successfully investing in a foreign market.

The U.S. Reality: In the United States, SelectUSA, America's IPA, has done a poor job connecting potential Chinese investors with investment opportunities in the United States. The agency has limited offices in China and inadequate presentations to lure investors to the U.S. market. Moreover, the SelectUSA website is vague, unhelpful, and inaccessible. Their page of "SelectUSA Services" has very brief and vague descriptions. Their homepage emphasizes reasons why the United States is a great investment destination, U.S. incentive offerings, and examples of businesses that chose to invest in the United States. However, the site lacks information and tools to educate an investor on how to invest, rendering it unhelpful. Additionally, the website has no Chinese language option, making it seem unwelcoming and inaccessible. The information gap in part results from the architecture of the U.S. government. Because cities and states have power independent of the federal government, their IPAs can do much of the promotion and information sharing, while the federal government IPA remains relatively inactive.

2. Unfriendly Environment

Chinese investors perceive the United States as an unfriendly destination to invest in. This partially results from the opaque nature of CFIUS. Regardless of why this stigma exists, the unfriendly environment is not only a Chinese perception. In truth, the United States has not been the most friendly environment for Chinese investment, as getting visas to work in the United States is incredibly difficult. SelectUSA could try to ease this process. The literature suggests that image building can be very important in attracting FDI, which unsurprisingly shows that this perception and reality of having an unfriendly environment hurts FDI flows. Additionally, promotion agencies can help image building, which demonstrates that SelectUSA could make an impact in this area.

3. Race to the Bottom

Current State of Coordination: States are currently more primary FDI promoters than the national government: states like California and Michigan have subnational IPAs that have thrived in promoting Chinese FDI. However, with the little effort from SelectUSA, coordination between the national and state IPAs has been lacking.

Impact on U.S. Welfare: As a result of this lack of coordination, a prisoner's dilemma among state IPAs has ensued, leading to a "race to the bottom" in which states increase incentives for potential Chinese investors, which results in lower total welfare for Americans. More coordination might improve this ugly side effect of the current US promotion architecture.

LEARNING FROM THE EU

Several EU countries have successfully employed strategies to promote Chinese FDI. EU countries, like American states, face a "race to the bottom" against each other, while the EU, like the U.S. federal government, faces competing state incentives within its territory. Although this issue has not been addressed much in the EU, the United States can learn from European countries that have succeeded in closing **information gaps** and creating an **open environment**. Three of these countries are **France**, **Germany**, and **Sweden**.

1. **France**

   Closing Information Gaps: France's IPA website includes China-specific messaging, a Chinese language option, and a "Doing Business in France" business guide. The French IPA also participated in the China Chongqing International Investment and Global Sourcing Fair in May.

   Creating an Open Environment: France has created a very open environment, as the minister of foreign affairs wants "Chinese businessmen to think of France as their second home."

2. **Germany**

   Closing Information Gaps: Germany's IPA website includes a messaging and appointment scheduling feature, a Chinese language option, and "Coming to Germany" and "Establishing a Company" guides. German IPA representatives also attend many events in China, such as China Med 2012 in Peking and Battery China 2013 in Beijing.

   Creating an Open Environment: Germany established the Dusseldorf China Center in order to help Chinese businessmen feel at home and demonstrate openness to their investment.

3. **Sweden**

   Closing Information Gaps: Sweden's IPA website includes a China page with contact information of the Swedish IPA offices in China, as well as upcoming events in China. It also features guides on how to start and run a business in Sweden.

   Creating an Open Environment: Sweden opened its first IPA office in China in 2002, has ten employees working on this effort, and operates on a relatively high budget to promote Chinese investment.

Table 2: China's FDI in the EU-27 by Country, 2000-2011

USD million, number of deals

	Country	Investment Value (USD million)	Rank Compared to FDI from the Rest of the World*	Number of Greenfield Projects	Number of Acquisitions	Total Number of Deals
1	France	5,722	+2	46	24	70
2	United Kingdom	3,684	-1	69	26	95
3	Germany	2,543	-1	113	33	146
4	Sweden	2,251	+4	14	6	20

IX. California: A Model for U.S. Investment Promotion

California possesses unique characteristics as a state. With the largest Chinese population in the United States, Chinese investors feel at home in California seeing familiar signage, authentic restaurants, and conversations in Chinese. A long history of business between China and California has produced seasoned business leaders who understand how Chinese companies function. Many publicy elected officials are Chinese Americans; for example, Mayor of San Francisco Ed Lee, Mayor of Oakland Jean Quan, and member of the California State Assembly Phillip Ting. California is a national leader in innovation, technological know-how, and service components of manufacturing value chains. The high quality of life, environmental cleanliness and R&D also attract Chinese investors.

The type of investment California attracts is also unique. According to the Rhodium Group Investment Tracker, China has invested in 181 investment deals worth 2.2 billion dollars in California between 2000 and 2013. Analysis of the Chinese investor base reflects that California secures a higher percentage of investment from private Chinese firms because many of the investment deals are for small start-up info tech companies. Additionally, in California, more greenfield deals occur than mergers and acquisition, demonstrating Chinese commitment to long-term investment in California. The most experienced and most sophisticated Chinese investors from the most advanced entrepreneurial hubs and provinces are drawn to California.

Chinese FDI: California vs. Rest of Country

NUMBER OF DEALS

	Rest of the United States						California					
	Greenfield Projects	% Share	Acquisitions	% Share	Total	% Share	Greenfield Projects	% Share	Acquisitions	% Share	Total	% Share
Government Controlled	80	32%	30	21%	110	28%	26	24%	5	11%	31	20%
Private and Public*	170	68%	111	79%	280	72%	83	76%	42	89%	125	80%

TOTAL INVESTMENT (MILLIONS OF U.S. DOLLARS)

	Rest of the United States						California					
	Greenfield Projects	% Share	Acquisitions	% Share	Total	% Share	Greenfield Projects	% Share	Acquisitions	% Share	Total	% Share
Government Controlled	1,837	64%	7,978	66%	9,816	65%	84	34%	38	4%	123	9%
Private and Public*	1,032	36%	4,174	34%	5,206	35%	163	66%	1,042	96%	1,206	91%

The top five sectors of Chinese investment

1. Software and IT services
2. Leisure and entertainment
3. Communications equipment and services
4. Electronic equipment components
5. Alternative and renewable energy

Concerns About Chinese Investment

While the concerns below draw on specific Californian cases, increasing Chinese investment will trigger the same types of concern in other states. It is necessary to understand the most common objections to Chinese investment.

1. **National Security**

   Example: CNOOC Unocal Deal

2. **Condoning Human Rights Abuse**

   Example: San Leandro city council members voted to ban flying Chinese flag because of worry that it sent a message tacitly supporting the human rights abuse that occurs in China.

3. **Labor Standard Noncompliance**

   Example: Build Your Dreams (BYD) is a Chinese company contracted to build 15 energy efficient buses that is being accused of not creating jobs for Californian workers and abusing Chinese workers by paying them $1.50 an hour with a daily allowance of $50.

4. **Foregone Employment Opportunities**

   Example: Shanghai's Zhenhua Construction Company won a 7.2 billion dollar deal to build new segments of the San Francisco Oakland Bay Bridge, which cost Californian workers employment opportunities.

How Concerns about Chinese Investment Create Larger Problems

With Chinese investment expected to increase from $1 trillion to $2 trillion between 2010 and 2020, 10-60 billion dollars of Chinese investment are in store for California. Thus, it is in California's interest to take proactive steps to

secure this investment. The issues below, if not addressed, could lead to California losing Chinese investment to other states or countries.

1. **Lack of Coordination between Local and Federal Efforts**

   SelectUSA, the federal investment promotion agency, does not match investors with American companies, but rather leaves it up to individual states to compete for foreign investment. States investment promotion agencies lack investment promotion coordination with national ones.

2. **Politicization of Chinese Investment Deals**

   Large acquisitions have received much attention in national media and stirred up heated political rhetoric, shifting attention away from objective evaluations of national security. The earnest efforts of organizations and individuals promoting investment on a local level may also be undermined as result of hostile national rhetoric, which compromises broader U.S.-China relations and may turn away potential investors, such as Huawei (now shifting investment in developed nations to focus on European Union.)

CALIFORNIA AGENCIES AND INITIATIVES

Despite the unique benefits and types of investments that California offers, it can nevertheless serve as a national model for public private partnership sponsored investment promotion efforts. Other states should model their investment promotion strategies after some of the successful efforts listed below.

1. **Conferences and Summits**

   Two-Day U.S.-China Summit in Palm Springs: President Obama and President Xi Jinping discuss developing further trade and investment opportunities

   Governor Brown Visits China to Promote California Investment Opportunities

   Assemblyman Philip Ting Leads Trade and Friendship Mission to China

2. **Private Groups**

   GGVCapital: venture capital firm specifically attracting investment between China and California

   Jeffer Mangels Butler & Mitchel LLP: private law firm with special branch of legal expertise to help Chinese investors identify, evaluate and manage real estate deals

3. **Non-profit Groups**

   ChinaSF: an economic initiative of San Francisco in close partnership with the San Francisco Center for Economic Development. ChinaSF's mission is to provide services to retain Chinese inbound investment, at the same time helping San Francisco companies expand into the China market. It has offices in Beijing, Shanghai and San Francisco.

   Bay Area Council: business sponsored, public advocacy organization. Council staff members both in the Bay Area and Shanghai help small, medium and large Bay Area businesses expand into the Chinese market, while working to attract Chinese businesses and investment. It hosts conferences and summits bringing together interested Chinese investors and local Californian business leaders.

4. **Governmental Groups**

   California Governor's Office of Business and Economic Development (Go-Biz): partner with Bay Area Council and maintains trade office in Shanghai.

   Select Committee on Asia/California Trade and Investment Promotion: identify best practices to facilitate relationships between the state of California and Asian companies interested in investment in California.

   California Governor's Office Financial Investment Incentives: provide R&D tax credits, tax breaks, industrial development bonds, etc.

X. A U.S.-China Bilateral Investment Treaty

In July 2013, at the fifth Strategic and Economic Dialogue (S&ED), China and the United States announced their intention to restart substantive negotiations of a BIT following Chinese agreement to discuss all stages of investment and all sectors during talks. The benefits to American investors of increased market access and protections in China and of increased domestic access to Chinese capital underscore the importance of concluding a BIT with China. Significantly, the United States is one of the few capital-exporting countries that does not have a BIT with China, which places American investors at a competitive disadvantage. Furthermore, a U.S.-China BIT could serve as a model for future American BITs with large developing countries.

Areas of Potential Conflict

U.S.-China BIT negotiations have previously been unsuccessful due to divergent provisions contained in each country's typical BIT. Areas of disagreement include national treatment (NT), pre-establishment rights, transfer of funds, and performance standards and standard setting.

1. National Treatment

China has traditionally been reluctant to accord NT to foreign investors, though recent Chinese BITs exhibit conformity to the principles of NT subject to a grandfather clause for any existing non-conforming measures. By contrast, the U.S. Model BIT requires NT for all relevant regulations except for existing non-conforming measures that are affirmatively specified in the BIT. Resolution of the NT issue will be especially difficult in light of the considerable favoritism China displays to indigenous companies, particularly its national champions. It should be noted, however, that the China-Seychelles BIT of 2007, which has not yet entered into force, provides for unconditional NT. This treatment is highly atypical, and, presumably, China only incorporated this standard because the amount of foreign direct investment it can expect to receive from the Seychelles is negligible. Nevertheless, because a U.S.-China BIT would most likely contain a most favored nation (MFN) clause, such unconditional NT might be available to American investors. In practice, though, it does not seem that any international tribunal has availed investors of a higher NT standard because of an MFN clause, making it unlikely that American investors would be able to leverage the NT standard of the China-Seychelles BIT.

2. Pre-establishment Rights

Chinese BITs typically only apply to post-establishment rights with the exception of the 2012 Chinese-Canadian BIT, which contains minimal pre-establishment investor rights. By contrast, American BITs protect substantial investor rights during all stages of investment. Significantly, the Chinese leadership has agreed that a U.S.-China BIT would cover all stages of investment with a "negative list" approach in which specified sectors would be exempt from BIT provisions that protect pre-establishment rights.

3. Transfer of Funds

Because China has restrictions on capital flows designed to maintain its exchange rate regime, its BITs do not permit the free transfer of funds. However, its recent BITs have more liberally facilitated the transfer of funds while still preserving the state's ability to restrict flows pursuant to national laws and regulatory formalities. American BITs mandate the free transfer of funds; this provision is only limited in a highly circumscribed set of circumstances. Compromise on the transfer of funds provision may be problematic as it is necessarily tied to China's controversial foreign exchange regime. However, there exists some precedent for the United States to conclude BITs that allow for capital flow restrictions. America's BITs with Egypt and Turkey, for example, contain such provisions though these clauses limit restrictions on capital transfers to situations in which foreign exchange reserves are extraordinarily low.

4. **Performance Standards and Standards Setting**

   The American Model BIT prohibits states from imposing a technology transfer requirement as a condition for the establishment or operation of an investment. This is problematic because China frequently requires concessional technology transfers from foreign firms in order to bolster its domestic development as a part of its "indigenous innovation" policy. Moreover, the American Model BIT requires that a party permit investors of the other party to participate in the development of industry standards set by the central government and to permit such participation on terms no less favorable than those accorded to nationals of the party. This provision will complicate negotiations as foreign investors are frequently barred from China's standard setting committees or are required to forfeit proprietary knowledge in exchange for participation in these committees.

IMPLEMENTATION ISSUES

Even if China and the United States succeed in concluding a BIT, senate ratification will likely be difficult to achieve. American senators have already expressed skepticism about the ability of a BIT to protect American investors and have articulated concerns that a BIT may ultimately favor Chinese investors while delivering no tangible benefits to American investors or the domestic economy. Such fears will be compounded by concerns that China has failed to satisfy commitments related to its ascension to the World Trade Organization. Additional domestic opposition is likely to come from environmental and labor groups who fear that American businesses may use a U.S.-China BIT to exploit poor standards in China.

The investor-state arbitration mechanism that is provided for in BITs and that is likely to be a central dispute resolution mechanism in a U.S.-China BIT may also be an ineffective means of protecting American interests. American investors may rationally fear that any arbitration brought against China would lead to future retaliatory treatment by China, making the costs of arbitration exceed the benefits even if the investor were successful in its claim. Despite being a party to BITs since 1982, China has been brought to international arbitration just once, and this dispute was settled before the arbitration formally commenced. Given that China's regulatory environment is far from perfectly equitable or consistent with the standards of NT, this dearth of cases may serve as indirect evidence that investors will be reluctant to use arbitration in order to enforce claims against China. This reluctance may undermine the ability of a BIT to protect American investors.

XI. Policy Recommendations

1. Improve the SelectUSA website to enhance outreach to potential Chinese investors

The U.S. Department of Commerce can improve investment promotion efforts by increasing information transparency, specificity, and accessibility. To compete with other industrialized economies, SelectUSA.org must effectively convey business opportunities available in the United States. A more effective website should:

- **Offer interface in multiple languages** to increase accessibility for foreign investors. Based on investment patterns and projections, potential languages might include: Chinese, French, German, Japanese, Portuguese, and Spanish.
- **Showcase in-depth success stories** of previous foreign investors through video clips, testimonials, etc.
- **Provide country-specific investment guides** tailored to investors from major countries, along with a set of standardized guidelines applicable to all foreign investors outlining best practices, such as philanthropy, corporate social responsibility, community outreach, etc.
- **Explain programs and services available** to businesses operating in the United States, such as taxes or subsidies, which may not be immediately apparent to foreign investors.
- **Increase the visibility of the messaging system** through which investors can ask questions to and get answers from Department of Commerce representatives.

These recommendations could be implemented by a few interns with language skills and background in public policy and website design, working under the supervision of Department of Commerce employees.

2. Correct misperceptions about investing in the United States through the CFIUS website

- **Implement multiple language options** to improve accessibility, giving priority to languages such as Chinese, French, German, Japanese, Portuguese, and Spanish.
- **Expanding on "Guidance Concerning National Security Review"** (2008), include a non-exhaustive and non-binding list of security issues and sensitive sectors that may fall under CFIUS jurisdiction. For example, the list of specific security issues could include:
    - acquisition of land in close proximity to a military installation;
    - sensitive sectors that are more likely to implicate "critical infrastructure or technology" such as defense, telecommunications, or energy.

  The list will also indicate that foreign government-controlled transactions are subject to added scrutiny under CFIUS review, which will mitigate the perception that the screening process is discriminatory towards Chinese investors.
- **Recommend that investors seek out private consulting agencies** to assist in cooperation with CFIUS throughout the process.

3. Coordinate investment promotion between local and national levels

Current competition between state investment promotion agencies (IPAs) is costly because it may result in a "race to the bottom" propelled by escalating incentives, decreasing overall U.S. welfare. We propose two means of improving coordination between subnational IPAs to address this issue:

- **Include a forum for state IPA representatives on SelectUSA's website**

  This forum would serve as a resource for state IPAs to discuss foreign investment and incentive programs. Ultimately, these discussions may lead to a consensus among subnational IPAs that fewer incentives are optimal.

This recommendation could be implemented by an intern to edit the website and advertisement of this resource, which could be done by SelectUSA reaching out to state IPA officers.

- **Organize a yearly conference for state IPAs**

  This conference would give state representatives a chance to speak face-to-face and discuss incentive strategies, fostering coordination. SelectUSA could also encourage coordination and strategic planning among state IPAs at this event.

  SelectUSA could appeal to members of the Committee of 100 or the U.S.-China Business Council to pay for and help organize the event.

4. EXPLORE PUBLIC-PRIVATE PARTNERSHIP AS AN AVENUE FOR INVESTMENT PROMOTION

Key business leaders and stakeholders from the U.S.-China Business Council and private firms already working with Chinese investors should team up with pro-Chinese investment politicians in all levels of government to form a visible partnership endorsing Chinese investment. This partnership can open channels of communication, bridging informational gaps between U.S. companies and Chinese investors as well as recommending sensible investment opportunities to potential Chinese investors. SelectUSA and local government investment promotion agencies should recommend suitable candidates from both private and public sectors to contribute to this federal level partnership.

As a coalition, the members should:

- **Publish standardized documentation of regulations** that Chinese investors must follow to address common American concerns about Chinese investment. These standards should be available in Chinese and visible on national and local investment promotion agency websites.
- **Send representatives from the public-private partnership** to create a strong local presence in China and communicate American investment opportunities directly to Chinese investors.
- **Expand investment promotion offices** and American representation to developed Chinese entrepreneurial hubs like those in Guangdong and Zhejiang provinces. Once established, such offices can also urge the Chinese to conform to American business standards.
- **Foster Chinese-American cultural exchange** and understanding by holding events (e.g., performances in both America and China) to reduce politicization of Chinese investment. Private individuals, corporations, or even local governments could fund these events to attract investment in a specific U.S. locality.

5. EXPAND CFIUS JURISDICTION TO COVER GREENFIELD INVESTMENT

Currently greenfield investment is not covered under the CFIUS mandate and is thus not subject to CFIUS review. However, greenfield projects may pose the same threats as do M&As. Thus, CFIUS should have the authority to investigate greenfield transactions.

6. WORK TOWARD A BIT WITH CHINA BASED ON AMERICA'S MODEL BIT AND CHINA'S RECENT INVESTMENT AGREEMENTS

American negotiators should employ the American Model BIT as a framework for determining the ultimate structure of the U.S.-China BIT. To do otherwise would set a dangerous precedent for future negotiations because the American Model BIT has proven successful in protecting investors.

In order to determine what deviations from the Model are necessary, American negotiators should reference China's recent BITs and free trade agreements (FTAs) with developed countries. China has signed BITs that confer substantial protections to investors, including its BITs with Germany in 2003 and Canada in 2012.

Additionally, the investment chapter of its 2008 FTA with New Zealand provides liberal protections of investors. These agreements contain clauses that will be useful in determining what China can be expected to concede on issues such as national treatment, pre-establishment rights, and performance requirements. Any attempt to demand concessions that far exceed the provisions contained in these agreements is likely to jeopardize the conclusion of a BIT.

7. Avoid adopting an economic "net benefit" test of FDI

A net benefit economic test is inappropriate in the American context for the following reasons:

- An aversion to industrial policy in the United States is deeply rooted in trust that market forces allocate resources most efficiently.
- There is neither a history nor expectation of Chinese firms posing an economic threat to the United States.
- An economic net benefit test would unduly deter beneficial FDI into American markets.
- Adopting an economic benefit test would undermine the pro-market international stance that benefits American corporations.

However, if CFIUS jurisdiction were to be expanded beyond strictly national security, we recommend an economic review confined to SOE behavior. Modeled on Australia's "behavioral conditionality" policy, the test should:

- Focus on the behavior of the U.S. subsidiary rather than the governance structure of the parent SOE. Basing SOE discipline on behavior rather than structure is simple and serves the immediate needs of competitive markets.
- Broadly define "market-compliant" behaviors much like antitrust legislation, to allow regulators flexibility when defining acceptable SOE behavior.

Minimal behavioral conditionality could include the following criteria:

- Adherence to common codes of business practice;
- Operational independence from home government;
- Profit-maximizing behavior.

Remedies to non-market behavior can include requiring the local subsidiary to list a minority share on a U.S. stock exchange, or requiring the establishment of local independent management. Commerce, which is already a member of CFIUS and is tasked with promoting economic growth, economic competitiveness, and sustainable development, should assume a lead role in regulating SOE discipline.

As evidence from Australia and Europe demonstrates, increased formal restrictiveness on FDI does not necessarily decrease total FDI; for example, Chinese investment in Australia continued to grow after a behavioral conditionality test was adopted in 2009. Rather, having explicit expectations for foreign investors and clear rules may in fact encourage FDI. Therefore, the United States could adopt behavioral conditionality to protect itself from harmful Chinese firms while still enjoying the benefits of increased Chinese FDI flows.

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