CFIUS, Chinese Investment, and How to Improve Both

By Derek Scissors  
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Key Points

- The People’s Republic of China is making a concerted effort to acquire American technology through both formation of national funds and bids by individual companies.

- The Committee on Foreign Investment in the United States should remain exclusively focused on national security, but the US should extend its investigations beyond traditional mergers and acquisitions, providing the necessary resources to do so.

- The US should be concerned with the nature of the American asset involved, not the ownership status of the foreign investor.

- Excluding national security concerns, the US should welcome Chinese investors, especially greenfield investors, that obey intellectual property and other laws.

In late summer 2012, American decision makers did not need to think much about Chinese investment. The amount of Chinese spending in the US in 2011 was small and declining, and even Huawei had not pulled a stunt for more than a year.1

There have been stark changes since. In late summer 2017, American decision makers have witnessed Chinese investment in 2016 in the $50 billion range, followed by another $17 billion in the first half of 2017.2 Greater Chinese investment brings economic benefits for the US, the most important of which is job creation or retention. The long-standing American position has been to welcome foreign investment as beneficial. This is correct and should not be changed, but noneconomic factors also need to be weighed.

Most pointed, the People’s Republic of China (PRC) is making a concerted effort to acquire technology, utilizing both national funds such as the one devoted to integrated circuits and individual bids for American assets such as Lattice Semiconductor.3 The security component of Chinese investment should be handled through the Committee on Foreign Investment in the United States (CFIUS), which is tasked with evaluating national security risk in foreign acquisitions. The top priority should be to reform CFIUS, including provision of additional resources, to ensure the now larger amount of Chinese investment and its more sophisticated nature do not compromise American security.

On top of economic benefit and security risk, an underappreciated aspect of foreign investment is ensuring rule of law. Based on the environment in their home market, some Chinese firms can be expected to engage in anticompetitive behavior or fail to meet complex American financial, environmental, and transparency requirements. What is already occurring, worldwide, is violation of intellectual property (IP) rights.4
The national security and rule-of-law threats can undermine the economic value of Chinese investment. The best CFIUS reforms are fairly simple, featuring an exclusive concentration on national security and extending CFIUS authority beyond mergers and acquisitions. Sectors and countries are better focal points than companies. But the approach should be multidimensional. Existing and potential infringement of American law calls for better enforcement as well as new legislation, including barring PRC firms engaged in serious lawbreaking. And the rise of Chinese investment globally calls for more coordination among US allies.

**Chinese Investment Patterns**

Chinese companies have increasingly targeted the US. In 2011, the PRC’s investment in the US had fallen sharply to just 3 percent of its global total. In 2016, its global investment jumped 45 percent to about $170 billion, and the American share of that much larger total was approximately 30 percent. The American share faded on-year in the first half of 2017, but both the share and the spending pace still easily eclipsed any year before 2016.

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Most of this is composed of transactions under CFIUS purview; that is, mergers and acquisitions (M&A). There are practical questions in distinguishing M&A from greenfield investment—the creation of new companies or facilities. But on a narrow definition of “greenfield,” this spending by Chinese companies fell globally in 2016 despite the overall boom.6 Only a handful of the $100-million Chinese investments in the US in 2016 were greenfield. In the first half of 2017, there were no $100-million Chinese greenfield investments in the US. Meanwhile, Chinese M&A in the US nearly quadrupled in 2016, and three-quarters of the $54 billion rise in the PRC’s worldwide outlays in 2016 was due just to M&A in the United States.

American policymakers are especially interested in the extent to which the PRC is spending on technology and infrastructure. American technology has drawn approximately $24 billion in Chinese funds since 2005, although little of the technology can be considered advanced. Investments in US infrastructure have amounted to only $6 billion or so, along with more than $1 billion worth of transport construction by State Construction Engineering in the New Jersey–New York area. There are also, of course, Chinese-owned assets proximate to US infrastructure.

The amount of American investment in the PRC may also be relevant. The Chinese government reports American investment at $3 billion in 2016 and $74 billion all told.7 The US Department of Commerce puts the 2016 figure at $64 billion and a historic total of $82 billion while an independent measurement puts the historic total much higher.8 Cutting through the differences, Chinese investment in the US has been much smaller until recently than American investment in the PRC. But Chinese investment in the US in 2016 utterly dwarfed American investment in the PRC, and that result is being repeated so far this year. American investment in the PRC should be a secondary consideration when making policy regarding Chinese investment here.

**Five Things to Do—CFIUS**

1. **CFIUS should focus on national security.**

   This one should be easy. Protecting national security is a critical task that should not be supplemented with other mandates. Because Chinese attempts to acquire technology are intensifying, CFIUS already faces increasing challenges in safeguarding security while conducting a prompt review process that does not unduly burden any legitimate foreign investor. CFIUS needs more resources and clear, narrow guidance from Congress and the executive, not a slew of additional demands.

   Moreover, CFIUS is not capable of evaluating “net benefits” or other economic criteria. It is difficult to imagine a modification of CFIUS or any agency that could somehow balance national security and economic considerations without becoming extremely unwieldy. The result would likely be protectionism by default, with the review process becoming very slow and conflictual and investments drying up. (Some advocates of net
benefits tests may consider this a feature, rather than a bug.)

2. Go beyond M&A.

An implication of focusing CFIUS on national security is it should not focus solely on M&A. M&A wins headlines, but the amount spent does not correspond to the national security threat. Greenfield investments and engineering contracts which are proximate to American defense assets should be brought explicitly under CFIUS authority because they can be security risks. This includes both geographic proximity and “use” proximity, such as telecom networks connected to those used by the military.

The future importance of this step is being missed. As argued below, greenfield investment is economically valuable. Chinese construction activity is globally massive. In both greenfield investment and engineering contracts, the PRC has the capacity to greatly ramp up its activity in the US, which could provide major benefits but also defang CFIUS as it is currently constituted.

There are also subtle business arrangements that should be reviewable by CFIUS. The current emphasis on outright M&A can be gamed, most obviously by making seemingly minor changes after an initial investment has been cleared. These include adding personnel with access to sensitive data or equipment or locating facilities overseas. CFIUS must have the authority to block these, or those seeking to acquire technology will evade the simple M&A review more frequently. The greater scope of CFIUS action would require more work and more resources. It justifies a greater emphasis on transparency and streamlining the new, expanded process as much as possible.

3. Adopt a “critical sectors” approach.

Incorporating greenfield investment under CFIUS would also help resolve the ongoing debate about critical infrastructure. Infrastructure immediately proximate, either geographically or in terms of use, to major defense assets should be deemed critical. At this time, nothing else should. Invoking rail, for example, as intrinsically important to national security by its nature is at best antiquated thinking and at worse a cover for economic self-interest. It would be reasonable for CFIUS to review and possibly limit any large buildup in foreign ownership of certain kinds of infrastructure. Given the size of the American economy, $100 billion in an infrastructure sector would be a good starting point for this. Individual deals certainly would not.

More broadly, it confuses American asset holders, foreign investors, and possibly even regulators to have infrastructure, technology, and materials all labeled as critical, in necessarily different ways. The way to cut through this is a list of restricted sectors which will always remain as short as possible and is modified on a regular basis, including dropping sectors from the list. It can include infrastructure which has seen heavy investment as well as new sectors with technology that may prove important. Startups in these areas would be restricted to foreign investors, until technology development was such that they could be fully opened.

The responsible authority for the list should be located in the Defense Department, while CFIUS is still tasked with implementation. As Treasury’s leadership of CFIUS is needed to avoid a cumbersome review process, a single agency must have control of what constitutes a critical sector. Otherwise, the list will expand to include assets not vital to national security, and its makeup could become politicized.

4. Target higher-risk countries.

An argument is sometimes made that CFIUS should be vague with regard to higher-risk countries, in order to preserve flexibility. After the surge in Chinese investment, this is no longer convincing. Vagueness invites a few malicious investors to game the process by claiming the same status as the huge majority of innocuous investors. Being specific about risks grants CFIUS the additional authority it now needs. The biggest economic problem with vagueness is it makes CFIUS interference in foreign investment more harmful than it needs to be. More Chinese acquisitions call for greater CFIUS interventions only in those acquisitions. The less transparency there is otherwise, the more investors will be deterred from spending in the US by the uncertainty, even if their investment
would be welcome and beneficial. Lack of information on what CFIUS is doing can thus make justified US government intervention in the market even more distorting than it should be.

Further, while asking for government to be open and honest may be naive, there is a more sophisticated case for transparency. We want global trade investment to be more transparent—see the current NAFTA negotiations— and we are on stronger ground demanding improvements when we have sacrificed some of our own flexibility for the cause. Finally, American technology restrictions will be more effective if allies mimic them (see below). To do so, our allies must clearly and fully understand what our restrictions are. This alone outweighs the criticism the US will receive from targeted countries such as the PRC.

5. Do not target state-owned enterprises.

There have been repeated suggestions that it would be valuable to block investment from state-owned enterprises (SOEs), either Chinese or all nationalities. This makes no sense in the context of CFIUS reform. An SOE buying a hotel not proximate to a military asset is obviously less risky for national security than a private entity (e.g., Chinese or Russian) trying to buy dual-use technology to sell to the highest bidder.

Banning SOEs makes little sense outside CFIUS. By far the biggest SOE investors in the US at present are Chinese, and they are not major investors overall. Last year may turn out to be a peak year for Chinese investment in the US for a decade to come. SOE technology spending in 2016 was less than $5 billion, and the bulk was in one deal, the acquisition of Lexmark, which is hardly a home for advanced equipment.

Even just as a precautionary measure, banning SOE investment is misguided. The Chinese Communist Party can control private firms directly through cells within the firms and through state-controlled courts. Private firms have no protection through rule of law and cannot refuse Party directives, making the national security risk from private firms no different than the risk from SOEs. On the economic side, if SOEs are barred, private firms will conduct the same investments, then partner with SOEs at home or in third markets. This is a waste of time.

Table 1. SOE Investment in the US, 2005–2017H1

<table>
<thead>
<tr>
<th>Year</th>
<th>Volume (USD Billion)</th>
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<tbody>
<tr>
<td>2005</td>
<td>1.7</td>
</tr>
<tr>
<td>2006</td>
<td>0.0</td>
</tr>
<tr>
<td>2007</td>
<td>8.3</td>
</tr>
<tr>
<td>2008</td>
<td>4.6</td>
</tr>
<tr>
<td>2009</td>
<td>8.2</td>
</tr>
<tr>
<td>2010</td>
<td>8.7</td>
</tr>
<tr>
<td>2011</td>
<td>0.5</td>
</tr>
<tr>
<td>2012</td>
<td>5.1</td>
</tr>
<tr>
<td>2013</td>
<td>4.2</td>
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<tr>
<td>2014</td>
<td>8.3</td>
</tr>
<tr>
<td>2015</td>
<td>9.7</td>
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<tr>
<td>2016</td>
<td>17.4</td>
</tr>
<tr>
<td>2017</td>
<td>1.7</td>
</tr>
<tr>
<td>Total</td>
<td>78.5</td>
</tr>
</tbody>
</table>


5. Do not target state-owned enterprises.

The US should do five additional things beyond the scope of CFIUS.

6. Do not restrict investment on economic grounds.

Having an office entirely separate from CFIUS to screen foreign investment on economic grounds is more sensible than trying to do everything in one shop, but it would still be an error. The single most important foreign investment is in US Treasury bonds. This can be limited simply through fiscal responsibility. If deficit spending persists, limiting foreign bond investment will merely make financing the deficit more expensive.

CFIUS reviews foreign investment in companies. Along with spending on assets such as property, this investment benefits Americans who see higher bids for what they own, from stock to houses. More important, foreign investment is
job-preserving and often job-creating. There is no evidence of mass uprooting of facilities and jobs moving out of the country. Even if the US was not permitted to invest overseas, it is in our self-interest to welcome most investment here. Simple reciprocity does not make sense economically.

In particular, the importance to the US of Chinese non-bond investment is very low. The highest estimate for Chinese non-bond investment in the US from 2005-2017H1 is $160 billion (from the American Enterprise Institute). At the end of last year, the Federal Reserve put American household net worth at more than $92 trillion. There is no flood of PRC money; rather, there is a drop in a very large bucket. In this light, piling up economic issues that must be evaluated and creating a bureaucracy to investigate purported economic risk may benefit policymakers facing election and technocrats seeking jobs but will do nothing for the country’s economic health.

7. Facilitate greenfield investment.

Greenfield spending is a reminder of the value of foreign investment. Acquisitions can directly risk national security and conceivably involve job loss, if employment is reduced more than it would be without the acquisition. Because it cannot involve technology loss and because it creates jobs at least in the short term, greenfield investment is usually preferable to M&A. It is thus unfortunate that the greenfield share of the PRC’s spending in the US has plummeted. The greenfield share was roughly 35 percent in 2015 but fell to 12 percent in 2016. In the first half of 2017, it was negligible. For Chinese investment to provide a measurable employment boost for the US, greenfield spending must become far more prominent.

Since the Chinese investment surge, there has been federal-local tension, with governors and mayors more welcoming than Washington. But federal and local government interests should align with regard to attracting greenfield investment. Subsidies should be minimal—subsidizing Chinese investment is frequently just handing money to the Communist Party through Chinese banks.

Instead, both Washington and state capitals can provide much-needed information: Washington, information about (new) CFIUS

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**Figure 4. Share of Greenfield Chinese Investment in the US by Year, 2005-2017 H1**

requirements and federal regulations, and state capitols, information about local regulations and business conditions. It cannot be emphasized enough that few PRC firms know how to function properly in a rule-of-law environment, such as with respect to zoning. Making them more comfortable is easy and cheap, and could bring billions in payoffs.

8. Enforce American laws better.

The lack of experience with rule of law has an obvious, considerable downside. The surge in Chinese spending in the US has brought firms here with no global track record. It is almost certain that some, bred under Party rule, will make mistakes in US operations, some of which they should be liable for. If many PRC firms were already breaking American laws, it would be glaring, and the absence is encouraging. But just the small number of Chinese firms breaking American law is disturbing, primarily due to the Party’s pernicious role.

The basic problem is “Fortress China.” Chinese courts are controlled by the Party, with decisions rendered for political reasons. A Chinese firm which breaks American law, say by making substandard goods, can take shelter there and American plaintiffs win compensation only if the Party instructs courts accordingly. Even then, Chinese courts almost never make large judgments, so incentives to flee to Fortress China are high when Chinese companies do more harm in the US.

It is not just PRC courts that can be a problem. Without clearer statutes, American judges may decide a Chinese firm violating American law is primarily an international issue. This may be legally complex, but as a matter of public policy, it must be clear. There is already an instance of Chinese firms violating American antitrust law and harming consumers yet being protected by US courts on the grounds the Chinese government forced them to do so. The door is open for Chinese law to trump American when Beijing wants, a problem Congress should start to address immediately and decisively.

Violations of antitrust and other US law are not matters of CFIUS failing to protect national security. Nor can they be solved by a separate economic gatekeeper. Enforcing American law requires monitoring after the initial transaction is complete and operations begin. This can be done through regulations singling out firms from countries with weak rule of law for monitoring beyond CFIUS, while offering technical assistance to help these firms with compliance.


Related to both rule of law and investment policy is violation of intellectual property. Investment reform and IP enforcement can certainly be done separately, but it is odd to strengthen CFIUS to protect national security while ignoring associated IP violations which may undermine national security. If foreign firms are barred from purchasing dual-use technology but then acquire it via theft (perhaps indirectly), what has been accomplished?

Beyond national security, IP is important enough to be a core issue in American economic policy. According to the US Patent and Trademark Office, industries which rely on IP employed 28 million people in 2014, adding $6.6 trillion in value to the economy. IP helped support 17 million other jobs.

The full threat to American IP plainly cannot be addressed solely through investment policy. But it would be an important step to separate good actors from bad by sanctioning foreign firms which use stolen IP while welcoming others. Firms found to have used stolen IP should be banned from investing in the US, including their

Table 2. Chinese investment in American Allies, 2005-17

<table>
<thead>
<tr>
<th>Country</th>
<th>Investment Volume (USD Billion)</th>
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<tbody>
<tr>
<td>Australia</td>
<td>89.9</td>
</tr>
<tr>
<td>Britain</td>
<td>46.6</td>
</tr>
<tr>
<td>Canada</td>
<td>47.4</td>
</tr>
<tr>
<td>France</td>
<td>19.5</td>
</tr>
<tr>
<td>Germany</td>
<td>24.4</td>
</tr>
<tr>
<td>Japan</td>
<td>3.7</td>
</tr>
<tr>
<td>USA</td>
<td>165.4</td>
</tr>
</tbody>
</table>

subsidiaries and joint ventures as well as new companies established solely to avoid sanctions. In combination with facilitating greenfield spending, this would make foreign investment considerably more beneficial.

10. Coordinate with our allies.

This is last but certainly not least. While the US attracts the most investment from the PRC, the size of the American economy means Chinese spending is far less important here than in most countries. Australia, for example, has received about 55 percent as much Chinese investment as the US, while its stock of national wealth is only 8 percent of the American total. Some American friends and allies are looking to control the tide of Chinese investment entirely for their own reasons, and American leadership in this matter will make it easier for them to do so.

Dual-use and commercially advanced technology turn American leadership from useful to crucial. Most technologies the US wants to control are available in some form, even if inferior, in other rich countries. New, US-only restrictions through CFIUS may scratch a domestic political itch but will be frequently ineffective in halting acquisitions unless others follow. Germany has already begun balking at Chinese bids for commercially sensitive companies, while Japan is eager to join US-led efforts to restrict dual-use technology.

However, there is considerably more work to do. Canada, for example, intensely solicited Chinese investment for the past several years. CFIUS reform is necessary to prevent technology from falling into the wrong hands, but it is only step one.

Conclusion

The PRC’s involvement in almost any issue introduces a number of distractions. For example, neither the business community fretting over market access nor labor unions demanding retaliation for Chinese trade practices should be allowed to dictate policies to encourage foreign investment but protect national security. Most important, the US needs to extend its national security investigations beyond traditional M&A and resource CFIUS accordingly. As this is done, greenfield investment should be especially welcomed, from those firms which strictly obey American law.

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Notes


6. The problem comes down to Chinese firms joining projects that have started, in principle, but made little or no progress and exist mainly to draw foreign money. This is common in developing economics.


