CHINESE INVESTMENT & STATE ECONOMIC DEVELOPMENT

– Legal and Policy Issues --

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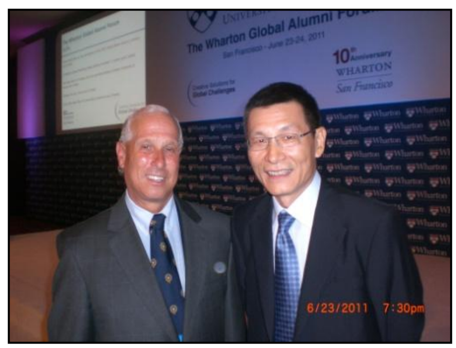
As a result of the 2008 global financial crisis and the Great Recession, states are confronting fierce fiscal challenges, and the job market is weak. In addition, the U.S. economy is not recovering as it has following past economic downturns. Now in the wake of the debt-ceiling crisis, the possibility of a double-dip recession is becoming a distinct possibility. In response to these increasingly bleak prospects, [1] states have become more aggressive in the global marketplace. Job creation is now viewed as the number one national and global issue.[2]

What should states and the federal government do to promote foreign direct investment (FDI) and economic development given growing concerns over national security?[3] This article focuses on Chinese corporate investment, discusses legal and policy issues, and concludes with several proposals.

States have only begun to systematically and aggressively recruit direct investment from foreign firms, especially those based in China. Focusing on attracting Chinese FDI is at least as beneficial as states utilizing traditional efforts of export promotion focused on small and midsized firms. A recent report by the Council on Foreign Relations concludes that "increased Chinese investment should be a top U.S. priority."[4]

The federal government has become more supportive of states as they expand their international economic development efforts. In addition to his revived push to create jobs and expand exports, President Obama's newer international investment initiatives are reaffirming traditional U.S. open investment policies. The intent of these policies is to remove regulatory uncertainties restricting FDI in the U.S. However, more needs to be done.



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The establishment of new foreign firms in a state has a major multiplier effect on local employment. For example, new firms often expand. In addition, as foreign firms' customers and suppliers increase, domestic firms grow. These new foreign-owned firms do not require many economic incentives or local tax subsidies to expand their operations into the U.S. since it is in their corporate interest to do so.

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[1] Editorial, "A Growing Gloom for States and Cities." *New York Times* (August 14, 2011).

[2] C. Blow, "For Jobs, It's War." *New York Times* (September 17, 2011).

[3] A recent study provides data on FDI in each state for 2004-2010 and ranks the recipient states. Burghard Group, "Global FDI Flows by Destination States, USA." (August 2011). Available from http://strengtheningbrandamerica.com/.

[4] A. Card, T. Daschle, E. Alden and M. Slaughter, "U.S. Trade and Investment Policy." 74 (Independent Task Force Report No. 67 of the Council on Foreign Relations, September 2011).

Establishing subsidiaries in the U.S. allows foreign multinational corporations to be located in the world's largest marketplace, avoid U.S. trade restrictions, take advantage of a cheaper dollar, and avoid currency fluctuations.

However, although states need foreign investments, federal government policies are still viewed by foreign investors as barriers to such investments. In addition, public support for these investments and state trade policies is often lacking. Such policies sometimes create popular resistance. Newer concerns related to national security and the remaining Cold War mentality of many politicians and Americans militate against welcoming investments from China and other emerging markets. Similar resistance occurred in the 1980s, when Japan Inc. invested in a large number of asset classes in the U.S. It continues today, fueled by some of the same anxieties about foreigners and spurred by newer ones involving cybersecurity, the rise of state-owned enterprises, cheap government funding, and foreign sovereign wealth funds.

In 2006, I wrote, "Transnational corporate undertakings have raised national security anxieties worldwide. Resource nationalism and renewed reaction to globalization further stir global anxieties."[5] The last five years have highlighted these developments to an even greater degree. This is especially true in light of the global recession and China's continuing growth.

The following observations are particularly important with regard to Chinese investment and state economic development in the U.S. today.

First, Chinese firms will make between $1 trillion and $2 trillion in direct investments globally over the next 10 years. Outward direct investment from China is growing at a rate 20% to 30% annually. Chinese corporate investments abroad have increased dramatically, with huge investments recently in Europe and Brazil. Foreign mergers and acquisitions by Chinese firms last year totaled $23.8 billion. This accounted for 40% of all FDI. China is now the second- largest acquirer of foreign business entities.[6] Private and state-owned Chinese firms use both retained capital and loans from state banks.

While investing much more in other countries, Chinese investment in the U.S. was $5 billion in 2010.[7] China has already invested in 35 of the 50 states, with the largest going to Texas, New York, and Virginia.[8] New York City alone has more than 60 private and state-owned Chinese companies registered with the city[9] and is the top city for Chinese FDI in the U.S.[10] China's overseas direct investment for this year is projected to increase at least 10%.[11]

The China Investment Corporation, a sovereign wealth fund, has invested its initial $200 billion.[12] Merely holding U.S. government debt and retaining large corporate and national dollar reserves is becoming unacceptable and overly risky for China and its corporations. The China International Capital Corporation, the respected investment bank, has recently opened offices in New York. Outbound direct investment from China is expected to overtake FDI in China within three years.[13] Chinese companies

[5] S. Malawer, "Global Mergers and National Security." *Virginia Lawyer* 34 (December 2006).

[6] L. Lan, "Overseas Spending Spree to Continue." *New York Times* (August 26, 2011) (article originally published in the *China Daily*).
[7] J. Flannigan, "A Wave of Chinese Money Gives a Lift to Companies Struggling in Tough Times." *New York Times* (July 7, 2011).
[8] D. Rosen and T. Hanemann, "An American Open Door – Maximizing the Benefits of Chinese Direct Investment." 32 (Asia Society) (May 2011). This report relies upon data provided by "The Chinese Investment Monitor," which is an excellent source of interactive data. Available from http://rhgroup.net/china-investment-monitor/
[9] Z. Yuwei, "Land of Opportunity." *Washington Post* (May 9, 2011).
[10] "FDI Global Outlook Report 2011." 12 (FDI Special Report) *Financial Times* (2011).
[11] D. Qungfen, "ODI Rebounds after July Decline." *Washington Post* (September 12, 2011) (article originally published in the *China Daily*).
[12] J. Dean, "China Fund Taps New CIO." *Wall Street Journal* (July 13, 2011).
[13] D. Qingfen, "ODI Set to Overtake FDI within Three Years." *China Daily* (May 6, 2011).

were among the fastest growing overseas investors in 2010.[14]

Second, Chinese operating firms are reorienting their global business strategies to avoid domestic trade restrictions and to more fully participate in the global economy to enhance their corporate transactions through acquisitions.[15] China has been the world's largest target for anti-dumping investigations, primarily in the U.S. and the European Union but now including other countries such as India and Brazil. As Chinese firms mature, they are clearly interested in developing strategies to overcome trade restrictions,[16] Buy America provisions, a falling dollar, and rising wages in China, as well as servicing their own domestic markets and developing newer global markets.

Publicly listed Chinese companies operating in the U.S., which often use reverse mergers[17] to avoid the scrutiny of an initial public offering (IPO), have raised issues concerning corporate transparency, governance, and fraud. Chinese firms often use foreign shell companies that issue American Depositary Receipts (ADRs) to attract U.S. investors.[18] The SEC, the Public Company Accounting Oversight Board (PCAOB),[19] and other bodies can ensure financial propriety by exercising diligent oversight of Chinese companies and their auditors. Various rules included in Sarbanes-Oxley[20] and Dodd-Frank[21] are specifically applicable extraterritorially and are useful in policing foreign investment in the U.S. in an era of cross-border transactions from a wide range of foreign companies.

Third, because of its concern for national security, the U.S. federal government has been needlessly hostile toward Chinese investment at times. The recent treatment of the Chinese-based company Huawei before the Committee on Foreign Investment in the U.S. (CFIUS)[22] this year was not helpful.[23] Huawei is the second-largest telecommunication equipment and networking company in the world and has extensive operations throughout Europe. It recently established the center of its U.S. operations in Texas.[24] Governors throughout the U.S. as well as their regional and national associations are active in promoting FDI to alleviate state distress.[25] The U.S. government plays an important role in reviewing foreign takeovers and acquisitions, but it should not become an overly politicized process aimed at parochial domestic interests.

Recent legislation, the Foreign Investment and National Security Act (FINSA), requires CFIUS to investigate all foreign transactions involving a corporation that is owned by a foreign government.[26] This provision seems to be aimed at China and sets

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[14] "FDI Global Outlook Report 2011." 3 (FDI Special Report) *Financial Times* (2011).
[15] "There is also the wider issue of how to address Chinese companies expanding global operations through acquisition that do not touch upon issues of national security." From S. Davidoff, "Actions of U.S. and China to Shape Deals to Come." *New York Times* (February 2, 2011).
[16] P. Rui, "Ending Trade Discrimination." *China Daily* (May 6, 2011).
[17] K. Scannell, "Reverse Mergers Test U.S. Regulators." *Financial Times* (July 5, 2011).
[18] J. Jannarone, "Not All Chinese ADRs are Created Equal." *Wall Street Journal* (July 28, 2011).
[19] D. McMahon & M. Rapport, "Challenges Auditing Chinese Firms." *Wall Street Journal* (July 12, 2011).
[20] M. Lambelet, "The Extraterritorial Effects of the Sarbanes-Oxley Act of 2002." (University of Geneva, October 2003).
[21] B. Protess, "Unearthing Exotic Provisions Buried in Dodd-Frank." *New York Times* (July 13, 2011).
[22] S. Raice, "Small Deal Brings Scrutiny to Huawei." *Wall Street Journal* (November 18, 2010).
[23] K. Hille, S. Kirchgaessner & P. Taylor, "China and the U.S.: Access Denied." *Financial Times* (April 7, 2011).
[24] Texas, one of the most politically conservative states, opted for recruiting Huawei despite the federal government's concerns over national security. C. Leonnig & K. Tumulty, "Perry Welcomed Chinese Firm Despite Security Concern." *Washington Post* (August 14, 2011).
[25] The National Governors Association's briefing, "Attracting Foreign Direct Investment into the States." (May 17, 2011). Available from http://www.nga.org; Southern Governors Association, "Economic Ties with China." (Annual meeting 2010). Available from www.SouthernGoverors.org.
[26] "Foreign Investment, CFIUS, and Homeland Security: An Overview." (GAO Report, February 2010).

the wrong tone if we want to encourage foreign investment. The same can be said for proposed legislation declaring currency undervaluation as a factor in determining illegal export subsidies.[27] It is interesting to note that China ranked only eighth in takeovers of critical technology companies in the U.S. from 2007 to 2009.[28] The *Financial Times* recently declared, "The Chinese rightly warn against protectionism wrapped in national security."[29]

Fourth, other countries, such as Canada, Australia, and Germany, have become leery of foreign takeovers, especially of industries involving commodities and agricultural land.[30] Reactions against foreign investment are rooted in national security concerns and opposition to deeper globalization, where foreign investment in domestic economies is becoming as important as trade between states. This foreign investment is highlighted by the expansion of foreign corporations from emerging markets into a broad range of domestic markets. This newer corporate activity involves not only sales but also manufacturing, research and development, and the provision of services in a domestic market.

Fifth, the traditional U.S. openness toward foreign investment must be further safeguarded. Although FDI in the U.S. increased by 49% in 2010, it is still lower than at its height prior to the 2008 financial crisis.[31] The U.S. should not only promote investments from our multinational corporations abroad but also welcome such investments from foreign multinationals and sovereign wealth funds from emerging markets, including China. Generally, state-owned enterprises operate to maximize their profits, as do purely private firms. Sovereign wealth funds also want to maximize their returns.[32] Secretary of the Treasury Timothy Geithner recently stated, "I am very confident that if you look over the next several years, you're going to see Chinese investment in the United States continue to expand very, very rapidly."[33] Vice President Joseph Biden wrote subsequently, "China can make our country more prosperous, not less. As trade and investment bind us together, we have a stake in each other's success."[34]

President Obama's declaration in June 2011 supporting a "fair and equitable" approach to foreign direct investment[35] is most welcome, as is his establishment of "SelectUSA" as the first coordinated federal effort to promote FDI in the U.S.[36] However, federal policies could further remove regulatory and congressional uncertainty relating to review of foreign mergers and transactions that are seen as risk factors restricting FDI. The federal government should become more aggressive in attracting FDI to the U.S.[37] The recent high-level task force report of the Council on Foreign Relations concludes, "Historically, the United States has never concerned itself in a systematic way with attracting and retaining foreign investment. As the world's largest market, it was simply assumed that big companies would make investing in the United States a high priority. That is no longer the case."[38]

Sixth, whereas federal enforcement of export controls on the transfer of technology to foreign affiliates in

[27] W. Morrison and M. Labonte, "China's Currency: An Analysis of the Economic Issues." (Congressional Research Service Report RS21625) (August 3, 2011).

[28] "CFIUS Annual Report to Congress." 20 (November 2010).

[29] Editorial, "Wen in Europe." *Financial Times* (June 25, 2011).

[30] "Law and Policies Regulating Foreign Investment in 10 Countries." (GAO Report, February 2008). See Table 1: "Selected Laws and Regulations Addressing Foreign Investment Restrictions" on page 8.

[31] Council of Economic Advisers, "U.S. Inbound Foreign Direct Investment." (June 2011).

[32] D. McMahon, L. Wei & V. Guevarra, "Wealth Funds Fight for Reputation." *Wall Street Journal* (May 10, 2011).

[33] "China's Investment in U.S. to Expand in Future: Geithner." Available from Xinhuanews at http://news.xinhuanet.com (May 10, 2011).

[34] J. Biden, "China's Rise Isn't Our Demise." *New York Times* (September, 8, 2011).

[35] "Statement by the President on United States Commitment to Open Investment Policy." White House (June 20, 2011).

[36] "Executive Order Establishing SelectUSA Initiative." White House (June 15, 2011).

[37] "(F)ederal, not just state-led, efforts to court foreign investors" are required for U.S. job creation." A. Card, T. Daschle, E. Alden and M. Slaughter. "A Pro-Trade Agenda for U.S. Jobs." *Wall Street Journal* (9.17.11).

[38] A. Card, T. Daschle, E. Alden and M. Slaughter, "U.S. Trade and Investment Policy." 74 (Independent Task Force Report No. 67 of the Council on Foreign Relations, September 2011).

the U.S. is necessary, as is securities review concerning any publicly listed foreign company in the U.S, policies do not need to be discriminatory. The conclusion of more bilateral tax and investment treaties with foreign countries by the federal government is an additional incentive for foreign firms to invest in the U.S.[39] Nevertheless, states must ensure that their tax and regulatory systems provide parallel rights.

Seventh, although members of the public and many policymakers do not generally realize it, states have become major players in international trade and global investment. This is occurring despite the fact that the U.S. Constitution gives Congress the exclusive right to regulate foreign trade and prohibits states from entering into treaties. The competition for new business takes place at the state level, one corporation at a time. States that are not aggressive or have regulatory and tax disincentives lose in the global marketplace.

Simply put, being competitive in the global marketplace is the answer to the economic and business distress at home. States should expand their global outreach by opening more offices overseas to sell their jurisdictions. Attracting Chinese corporations will not likely raise complaints about corporate welfare because they probably will not require expensive state incentives. Similarly, attracting such corporations will preclude the complaints of beggar-thy-neighbor and the race-to-the bottom-mercantilism that are often heard when one state persuades a firm from another state to relocate. Chinese companies are joining the global marketplace because of internal corporate dynamics to gain greater market access and profitability. As a result of these newer global strategies, market forces are forcing the Chinese companies to comply with national rules governing business transactions. This parallels China's general observance of trade decisions against it in the WTO's dispute resolution system.[40]

In conclusion, after assessing the legal and policy issues concerning Chinese investment in the U.S., I have several suggestions. First, states need to follow an aggressive economic development policy focusing on attracting Chinese and other FDI. States ought to assess their business and regulatory environments to ensure equal treatment for foreign corporations. Second, the federal government ought to remove unnecessary legislative and regulatory barriers to foreign investment in the name of national security that promotes protectionism. It should promote FDI aggressively. The federal government should promote greater use of bilateral investment and tax treaties to encourage greater foreign investment. Foreign corporations and sovereign wealth funds have the money and desire to invest in the U.S., which is good for the U.S. job market.

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[39] T. Siegmann, "The Impact of Bilateral Investment Treaties and Double Taxation Treaties on Foreign Direct Investments." SSRN 1268185 (November 2007).

[40] An analysis of Chinese litigation in the World Trade Organization discloses that China implements the decisions of the World Trade Organization's dispute resolution system and observes the rules of global trade once they are litigated. S. Malawer, "U.S.-China WTO Litigation (2001-2010). " 59 *Virginia Lawyer* 28 (December 2010).