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The Potential Risks of the EU's Investment Screening for the United States

Ted R. Bromund, PhD

KEY TAKEAWAYS

The EU's new framework for screening foreign direct investments bears no similarities to the U.S. system, whether in form or likely effectiveness.

The EU framework is riddled with weaknesses and perverse incentives, failing to balance welcoming foreign investment and preventing autocratic influence.

The U.S. must continue to improve national investment screening and be ready to protest when the EU uses its framework to reject legitimate U.S. investments.

Foreign direct investment in the United States—and in Western democracies more broadly—is usually beneficial and welcome. It creates jobs, builds businesses, and serves as a vote of confidence in the political stability and legal predictability of the Western democracies. But on occasion, foreign investment can come with strings that give foreign autocracies unwelcome influence on firms or capabilities that are vital to national security. The purpose of national investment screening is to ensure that democracies can enjoy the benefits of foreign direct investment while preventing investments that are made with malign intentions.

The European Union has recently adopted a framework for screening foreign direct investments. Given the many connections between the U.S. and the member states of the EU, it is desirable that those member states improve their screening of foreign direct investment. Indeed, improving this screening has been a major goal of the U.S.'s recent reform of its own screening system. But the EU's framework is unlikely to be effective in its current form. Worse, there are reasons to be concerned the EU will use its framework against investment from the U.S. The U.S. should focus on improving investment screening at the national level inside and outside the EU, and vigorously protest any use of the EU's screening system against the United States.

The EU's Investment Screening Framework

The EU's adoption of a framework for screening foreign direct investment began with proposals from the European Commission that were published in September 2017. The text of the framework was agreed by the European Parliament, the commission, and the Council of the European Union in November 2018; and the council approved the resulting regulation on March 5, 2019.[1] In intent, the EU's framework is often asserted to be similar to the Committee for Foreign Investments in the United States (CFIUS), which is the U.S. system for foreign investment screening. But the EU's system has a fundamentally different design, and comparisons to CFIUS are misleading.

Unlike CFIUS, which can block certain kinds of foreign investment in the United States, the EU's framework does not have the power to block foreign investment in EU member states. The EU's framework leaves the decision on whether to implement screening procedures, or to accept or reject a particular investment, to individual EU countries. But the EU framework allows both the European Commission and other EU member states to intervene in screening procedures that are begun by a member state:

- If a member state chooses to review a potential foreign investment through its national screening procedures, it must inform the European Commission and other EU member states that such a review is under way.

- If another EU member state considers this foreign investment to pose a risk to its own security or public order, it can address comments to the member state conducting the review.

- The European Commission is obligated to review all investments screened at the national level. If the commission believes that investment affects security or public order in more than one EU member state, it *may* issue a non-binding opinion. If at least one-third of EU states express concerns about an investment, the commission *must* issue such an opinion.

- Each EU member state also has the right to ask the commission to issue an opinion on the procedures carried out by the member state screening the potential investment. In other words, the commission can issue opinions on the procedures used to screen investments at the national level, as well as on the investments being screened.

Finally, the commission has a more direct role of supervising all investment within the EU that might affect official EU projects. If the commission finds that an investment might affect these official EU activities, it will issue an opinion to the EU member state that is the destination of the investment. Thus, while the EU's framework will normally work on the basis of information provided by, and complaints made by, the EU member states, the commission also has the power to act on its own when it believes EU projects to be at risk.

The Weaknesses of the EU's Investment Screening Framework

All investment screening systems must balance desirable objectives, and, as a result, any conceivable system has both advantages and disadvantages. But the EU's investment screening framework is so riddled with weaknesses that it is difficult to take seriously as a useful contribution to the West's need for systems that strike a reasonable balance between welcoming foreign investment and protecting the West from undesirable autocratic influences.

The weaknesses of the EU's system are:

1. **Perverse screening incentives.** The EU system only comes into play if an EU member state has both a national investment screening system and chooses to use it to review a potential foreign investment. The simple way to avoid the EU system, therefore, is either not to have such a system, or not to use it. The EU system may therefore incentivize EU member states to avoid reviewing potentially problematic foreign investment, or to avoid setting up a national system at all. In short, the EU framework may lead to less screening, or less-effective screening, of foreign direct investment in the EU's member states.

2. **Inability to prevent unwelcome investments.** The EU framework relies on the non-binding opinions issued by the European Commission, and the expressions of concern from other EU member states. But if an EU member state is determined to proceed with an unwise project—as Germany has been with the Nord Stream 2 gas pipeline, for example—this framework will do nothing to prevent the project from going ahead. This is particularly true if the nation accepting the investment is one of the EU's more influential members. In other words, the EU framework offers little more than the illusion that the EU screens foreign investment, and that illusion could actually encourage autocratic nations to view the EU member states as welcoming destinations for investments from autocratic regimes.

3. **Risk of trading favors in investment screening.** The EU framework creates the risk of trade-offs on undesirable investments between EU member states, and between the member states and the commission. If two EU member states are each reviewing a potentially undesirable investment, it would be simple for them to agree not to protest each other's investment, and thereby to short-circuit much of the EU framework. Similarly, EU member states will undoubtedly lobby the commission not to condemn investments that the member states wish to accept, and the lobbying of the EU's larger members is likely to be more effective than that of its smaller ones. Put simply, it is one thing for Greece to lobby the commission, and another if it is Germany doing the lobbying. In this environment, it is likely that commission decisions on whether to issue an opinion on an investment will be made on political considerations, not merit.

In short, the EU's framework is a Rube Goldberg apparatus of non-binding opinions and expressions of concern that bears no effective resemblance to CFIUS. Unfortunately for the U.S., the EU's framework is unlikely to be effective, and its weaknesses are both obvious and easily exploitable. When it works, it will work unpredictably, which is bad for investors; when it fails, it will do so unpredictably, which makes it unreliable. Indeed, the EU's framework is such a hodgepodge that it raises the suspicion that it is meant to fail, and thereby to create an imperative for empowering the EU to take over all investment screening inside the EU at the expense of the sovereignty of its member nations.

The EU's Investment Screening Framework May Be Directed Against the U.S.

Assessments of the EU's foreign investment screening framework have universally accepted that it is directed primarily against China, with Russia a secondary target. There can be little doubt that China, in particular, is indeed one target of the framework. The European Commission's statement in its 2019 report on China that "China can no longer be regarded as a developing country" has been widely remarked upon, and commentators assert that the commission's—and the EU's—attitude toward China has shifted against what Sophie Meunier, co-director of Princeton University's European Union Program, calls "the backdrop of surging Chinese investment in Europe over the past decade."[2]

But China is not the only likely target of the EU's framework. This is because the framework is aimed as much at protecting official EU programs as it is at deterring undesirable investment into opportunities that are not official EU programs. The EU has published a list of eight official EU programs to which the commission will apply its investment screening framework:

1. **The European Global Navigation Satellite System (GNSS).** The EU describes its GNSS program, called Galileo, as follows: "Until now, GNSS users have had to depend on non-civilian American GPS or Russian GLONASS signals. With Galileo, users now have a new, reliable alternative that, unlike these other programmes, remains under civilian control. While European independence is a principal objective of the programme, Galileo also gives Europe a seat at the rapidly expanding GNSS global table."[3]

2. **The Copernicus program.** This is a satellite-based earth monitoring program. The EU states that Copernicus "should ensure an autonomous Union capacity for spaceborne observations and provide operational services in the field of the environment, civil protection and civil security."[4]

3. **The Horizon 2020 program.** This is a funding program to promote research and innovation. The EU states that it is a "flagship initiative aimed at securing Europe's global competitiveness. Seen as a means to drive economic growth and create jobs, Horizon 2020 has the political backing of Europe's leaders and the members of the European Parliament."[5]

4. **Trans-European Networks for Transport.** This is a policy that "supports the completion of 30 Priority Projects, representing high European added value, as well as projects of common interest and traffic management systems that will play a key role in facilitating the mobility of goods and passengers within the EU."[6]

5. **Trans-European Networks for Energy.** This is a policy that is "focused on linking the energy infrastructure of EU countries.... The EU helps countries...to work together to develop better connected energy networks, and provides funding for new energy infrastructure."[7]

6. **Trans-European Networks for Telecommunications.** This is a policy to "support the trans-European deployment of services based on telecommunications networks. EU investment is currently focused on modernising existing networks."[8]

7. **The European Defence Industrial Development Program (EDIDP).** The European Commission describes this program, and its associated fund, as an effort to "foster an innovative and competitive defence industrial base and contribute to the EU's strategic autonomy."[9]

8. **Projects related to Permanent Structured Cooperation for Defense (PESCO).** The European Council on Foreign Relations states that PESCO is a contribution to "European strategic autonomy [that] is—like European sovereignty and strategic sovereignty—one of many concepts that seek to promote a more capable, independent EU at a time of growing geopolitical competition."[10]

In short, of the eight EU programs covered at the level of the commission by the EU's investment screening framework, four (GNSS, Copernicus, EDIDP, and PESCO) are explicitly intended to promote the EU's independence or autonomy from the United States, and one (Horizon 2020) is intended to promote the EU's global competitiveness against, among other nations, the United States. It would be remarkable if the EU decided to allow U.S. investment—in particular, controlling investment—into any of these projects. It is therefore likely that, insofar as the EU's investment screening framework is effective, it will be directed not only against investments from China, but also from the U.S.

The EU's framework may also work against investments from the U.S. even when the EU is reviewing investments in projects outside the eight official EU programs. Commentators have observed a tendency in recent years for Europeans to argue that the world is being divided up—or has been divided up—into spheres of U.S., Chinese, and European influence,[11] and that Europe must develop the capability to act independently of the U.S. if it is to survive in this divided world dominated by the great powers. Indeed, the concepts of independence and autonomy that form the basis for projects like PESCO testify to the strength of these beliefs.

In a world where the German economics minister is willing to explicitly compare the U.S. to the People's Republic of China, it is not farfetched to fear that the EU may decide that U.S. investment in major infrastructure projects, advanced technologies, or industries that provide public services poses a threat to the EU's security or public order.[12] It is, of course, highly unlikely that the EU would act against all U.S. investment, or even the vast majority of it, but the EU's eight projects have established the precedent that certain activities are so important to the EU's autonomy that they need special protection, and that is a precedent that could easily be expanded to cover other opportunities that U.S. investors may wish to consider.

What the U.S. Should Do

In 2018, the U.S. adopted the Foreign Investment Risk Review Modernization Act (FIRRMA) of 2018, which updated CFIUS. Included in FIRRMA is a provision calling on the President to "conduct a more robust international outreach effort" to help U.S. allies establish procedures similar to those of CFIUS. FIRRMA also instructs the chair of CFIUS to establish formal information-sharing procedures with U.S. allies. Until February 2022, CFIUS will determine whether European states have adequate national-security-based investment review processes.[13] With improved foreign review procedures and better information sharing in place, CFIUS will be able to participate in what one authority describes as "coordinated, multilateral national security reviews of multinational cross-border investments."[14]

The weaknesses of the EU's investment-screening framework means that it will make little, if any, contribution to the international outreach effort called for by FIRRMA. Indeed, the framework's potential perverse effects mean that it may even hamper the closer coordination between the U.S. and its allies that FIRRMA seeks to promote. The EU's investment screening framework thus cannot be considered an adequate national-security-based investment review process for the purposes of CFIUS's modernization efforts.

Therefore, the U.S. should:

- **Continue to focus on improving foreign investment screening at the national level.** Both inside and outside the EU, the U.S.'s goal should be for its allies to develop and enhance effective systems for screening foreign direct investment for potential security risks. Because the EU's framework relies on national systems, it is clearly no replacement for such systems. The goal and the mechanisms that the U.S. has set out in FIRRMA are appropriate, and the U.S. should not be distracted from them by the EU's adoption of its own investment-screening framework.

- **Protest vigorously against any EU use of its framework against the U.S.** It is likely that the EU's foreign investment screening framework will, sooner or later, be used against an intended investment from the United States. The U.S. must be ready for this possibility, and, as soon as it materializes, must make it clear to the EU that any use of the framework against the U.S. would pervert the purposes for which capitalist democracies adopt mechanisms for screening foreign investment, and would constitute a serious breach of trust between the U.S. and the EU.

Analysis of the EU's foreign investment screening framework has been distorted by the assumption that the EU shares the U.S.'s approach for understanding and dealing with the problems of foreign direct investment that is made with malign intentions. The EU framework has been repeatedly compared to the CFIUS, when in reality the EU's invention bears no similarities to CFIUS, whether in form or likely effectiveness.

More serious still, commentators have assumed that, because the U.S. is concerned about the intentions behind some Chinese foreign direct investment, the EU must therefore be driven by identical concerns. While the EU undoubtedly shares some of the U.S. concerns about China, it will also seek to use its new framework to defend EU projects that are intended to protect and enhance its autonomy from the United States. The U.S. must be ready to protest if and when the EU uses this framework to reject U.S. investment that, unlike malign investment from China, originates in an allied nation and is clearly being made for legitimate commercial purposes.

Ted R. Bromund, PhD, is Senior Fellow in Anglo–American Relations in the Margaret Thatcher Center for Freedom, of the Kathryn and Shelby Cullom Davis Institute for National Security and Foreign Policy, at The Heritage Foundation.

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