

GAO

Report to the Chairman, Committee on
National Security, House of
Representatives

April 1996

FOREIGN INVESTMENT

Foreign Laws and Policies Addressing National Security Concerns



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United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-270033

April 2, 1996

The Honorable Floyd Spence
Chairman, Committee on National Security
House of Representatives

Dear Mr. Chairman:

In a prior report to you,¹ we examined implementation of the Exon-Florio legislation² and related amendments by the interagency group, the Committee on Foreign Investment in the United States (CFIUS). This legislation authorizes the President to suspend or prohibit foreign acquisitions, mergers, or takeovers of U.S. companies when there is credible evidence that a foreign controlling interest might threaten national security and other legislation cannot provide adequate protection.

As agreed with your office, for comparative purposes, we undertook a follow-on effort examining how other countries monitor foreign direct investment in their national security-related industries.³ We compared the Exon-Florio legislation with the laws of four major investors in the United States—Japan, France, Germany, and the United Kingdom. Specifically, we focused on (1) the legal framework governing foreign direct investments posing potential national security concerns, (2) the barriers and incentives for U.S. companies to invest in these countries' national security-related industries, and (3) the U.S. companies' business activities in response to these barriers or incentives. In addressing the second and third objectives, we focused on the defense industry because it has the most direct link to a country's national security. Details on our scope and methodology are presented in appendix I.

Results in Brief

Japan, France, Germany, and the United Kingdom each have the authority to block investments for national security reasons, as does the United States. However, all five countries have infrequently used this authority in recent years. Some of these countries have established processes for reviewing foreign investment for national security concerns. Japan and

¹Foreign Investment: Implementation of the Exon-Florio and Related Amendments (GAO/NSIAD-96-12, Dec. 21, 1995).

²The Exon-Florio legislation was a provision of the Omnibus Trade and Competitiveness Act of 1988 and is part of the Defense Production Act of 1950, 50 U.S.C. app. 2170.

³For the purposes of this report, national security-related industries include—but are not limited to—companies that have defense contracts or make defense sales.

France review certain foreign direct investments for national security and other concerns. Germany and the United Kingdom have no general screening authority that explicitly considers national security issues related to foreign investment, but the United Kingdom can consider harm to public interest in its antitrust review process.

U.S. defense company officials we interviewed said they had not pursued defense-related direct investment in Japan, France, Germany, or the United Kingdom because of basic economic factors such as the size of the defense markets in these countries, as well as informal barriers, such as domestic company ownership structures. The officials said that such factors could be more important considerations in some countries than the legal framework. Most countries offer investment incentives, but U.S. defense company officials did not cite these as a major reason for investing.

U.S. defense company officials said they were pursuing access to overseas defense markets through strategies other than foreign direct investment. For example, U.S. defense companies either licensed technology to Japanese companies or made direct sales to Japan. In the three European countries, U.S. companies formed partnerships to compete for particular projects.

Background

International mergers and acquisitions have increased in recent years, returning to the high levels of activity that characterized the late 1980s. Cross-border mergers in Europe in 1994 were almost double the level of 1993 in value terms. U.S. firms were the most active buyers in Europe. Similarly in the United States, foreign companies significantly increased their investment activity. However, Japanese companies decreased their overseas acquisitions in the first half of 1994.

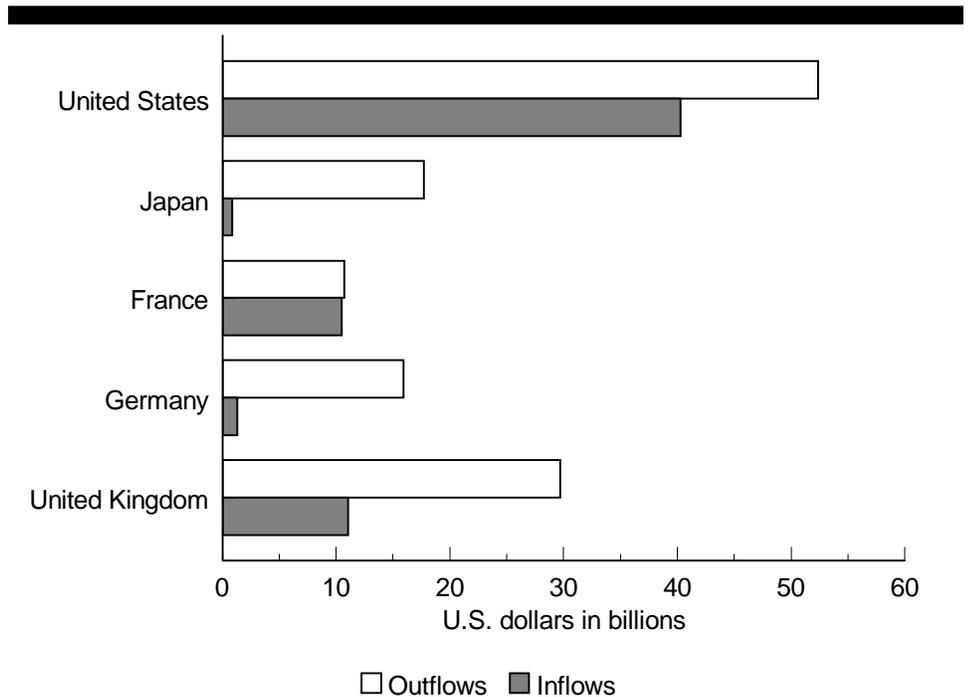
According to the Organization for Economic Cooperation and Development (OECD),⁴ total foreign direct investment⁵ inflows and outflows among member countries have increased in recent years. OECD reported that inflows grew by almost 60 percent for selected countries while outflows grew by 14 percent in the 1993-94 time period. The growth

⁴OECD is a forum for monitoring economic trends and coordinating economic policy among its 26 member countries, which include the economically developed free market democracies of North America, Western Europe, and the Pacific.

⁵The OECD definition of foreign direct investment is capital invested for the purpose of acquiring a lasting interest in an enterprise and exerting a degree of influence on that enterprise's operations.

of inflows is largely attributable to massive inflows into the United States. However, there is a significant variation in flows across individual countries, as shown in figure 1.

Figure 1: Foreign Direct Investment Inflows and Outflows, 1994

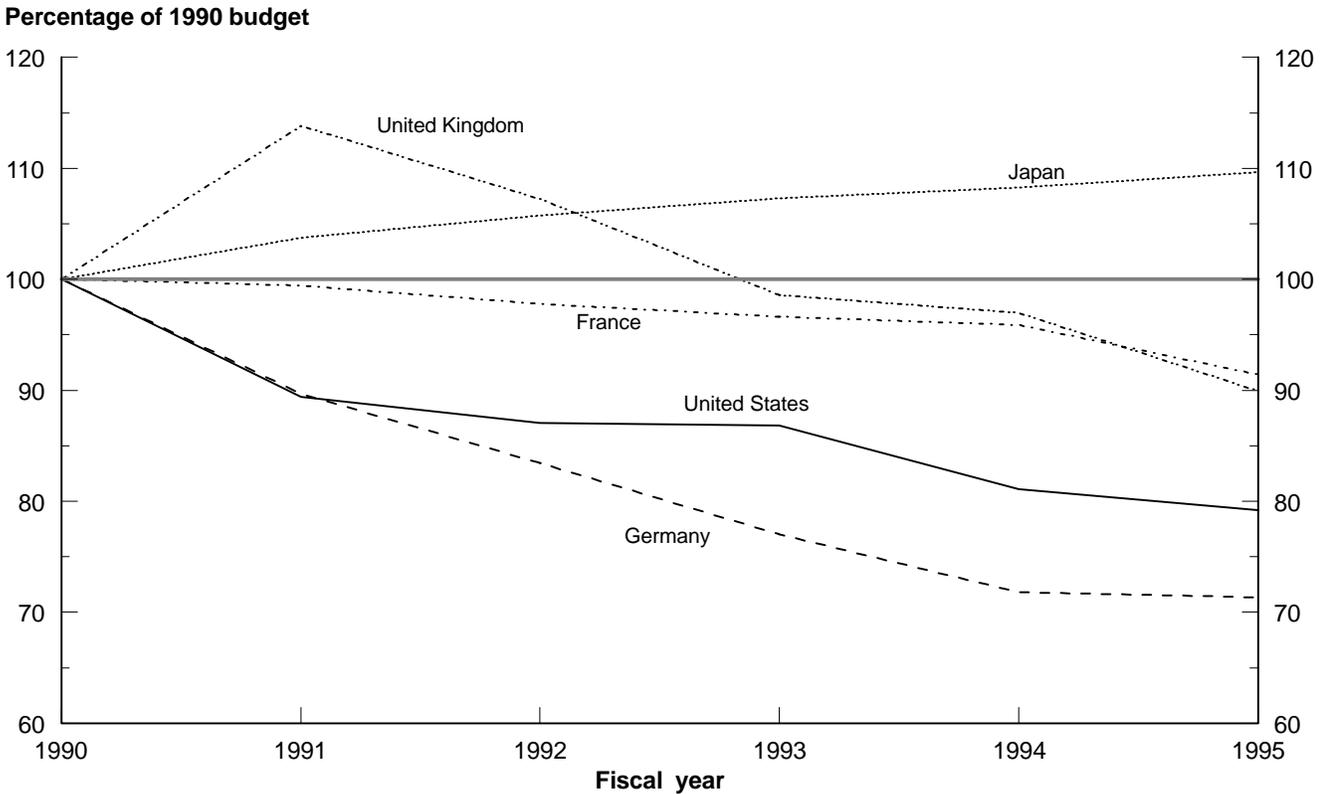


Source: Recent Trends in Foreign Direct Investment, OECD, April 3, 1995. U.S. data from Survey of Current Business, U.S. Department of Commerce, August 1995.

Defense Industry Activities

In the defense industry, company business activities have been affected by declining defense budgets. As shown in figure 2, France, Germany, the United Kingdom, and the United States have decreased their defense budgets in real terms over recent years. In contrast, Japan's defense budget has been increasing but at a decreasing rate, from a 3.8-percent increase between 1990 and 1991 to a 0.9-percent increase between 1993 and 1994.

Figure 2: Trends in Defense Budgets for Selected Countries, 1990-95^a



Source: GAO analysis based on The Military Balance, 1990-96, International Institute for Strategic Studies.

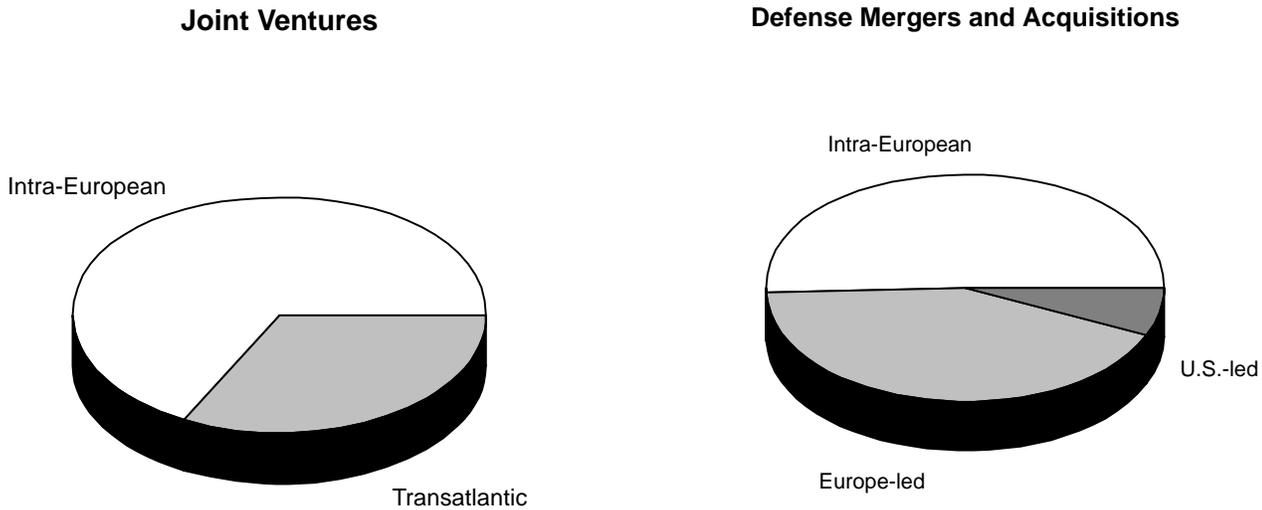
^aThe data are adjusted for inflation and indexed using 1990 as the base year.

Given declining defense budgets, most defense firms worldwide are consolidating to improve competitiveness. U.S. defense firms have pursued consolidation within the United States to downsize and reduce overcapacity. To a certain extent, some of the European countries have contracted and restructured their individual defense industries. Germany and the United Kingdom, in particular, have encouraged numerous defense manufacturers to consolidate into unified conglomerates or “national champions.” In contrast, French defense companies have consolidated more slowly. Mergers and acquisitions are uncommon in Japan’s defense industry, which is restructuring by such means as shifting resources away

from defense production into commercial sectors and reducing production lines.

According to the Center for Strategic and Budgetary Assessments,⁶ cross-border defense mergers, acquisitions, and joint ventures have been largely intra-European, as shown in figure 3. Transatlantic defense investment activity has been characterized by European acquisitions of U.S. companies rather than U.S. acquisitions of European companies. Few U.S. companies are acquiring Japanese companies. The Center for Strategic and Budgetary Assessments also reports that foreign acquisitions occurring in Japan are between companies only marginally engaged in defense work.

Figure 3: U.S.-European Cross-Border Defense Mergers, Acquisitions, and Joint Ventures



Source: Center for Strategic and Budgetary Assessments.

Note: Europe-led and U.S.-led refer to transatlantic mergers and acquisitions.

⁶The Center for Strategic and Budgetary Assessments (formerly the Defense Budget Project) is an independent research organization that analyzes national security policies and defense budgets.

International Agreements With Provisions Affecting National Security

Agreements among countries have widely recognized the right of sovereign nations to take measures protecting their essential national security interests. For example, article 223 of the Treaty of Rome⁷ states in part that European member nations may take measures “necessary for the protection of the essential interest of its security which are connected with the production of or trade in arms, munitions and war material.” This article essentially allows national governments to suspend European Union free trade and competition rules on the grounds of national security. Also, OECD’s main foreign direct investment instruments, the National Treatment Instrument and Codes of Liberalization, recognize that countries can take actions based on essential security or other interests.

In September 1995, OECD began negotiating a multilateral agreement on investment. This agreement is intended to develop high standards for liberalization of foreign direct investment regimes and investment protection and to include effective dispute settlement. Exceptions to the investment principles will be negotiated. According to some experts, one exception will permit each member country to exempt certain industries or sectors from the agreement commitments due to national security concerns.

Broad Authority Exists to Block Investments for National Security Reasons

The Exon-Florio legislation grants the President of the United States the authority to take appropriate action to suspend or prohibit foreign acquisitions, mergers, or takeovers of U.S. businesses that threaten to impair the national security. To exercise this authority, the President must find that (1) credible evidence exists that the foreign interest exercising control might take action that threatens to impair national security and (2) provisions of law, other than the Exon-Florio legislation and the International Emergency Economic Powers Act, do not provide adequate authority to protect the national security. Since the enactment of the legislation in 1988, the President has used this authority once when ordering divestiture of a Chinese company’s acquisition of a U.S. aircraft parts company.

Japan, France, Germany, and the United Kingdom do not have laws directly analogous to the Exon-Florio legislation, but nevertheless have broad legislative authority to block foreign investments for reasons of national security or national interest. For example, the Japanese and French laws provide the governments broad powers to block investments that might imperil national security, public order, and public safety. The

⁷The Treaty of Rome established the European Economic Community.

Japanese government has not invoked this authority in recent years while the French government has restricted nine investments in the past several years.⁸ Germany's law also permits restriction of private investment flows in either direction for balance of trade considerations and foreign policy, public order, and national security reasons, but such restrictions have not been used to date. The United Kingdom has never used its broad discretionary power to block foreign investments for national interest. The legal investment frameworks of Japan, France, Germany, and the United Kingdom are discussed in appendixes II, III, IV, and V, respectively.

In the United States, the President designated CFIUS as responsible for reviewing foreign investment transactions. Although notifications are voluntary, CFIUS retains the right to review at any time any acquisition not notified to the Committee. The Exon-Florio regulations also permit a CFIUS member to submit a notice of a proposed or completed acquisition for a national security review. A CFIUS determination that there are no national security issues essentially eliminates the risk that the President will at a later time block the transaction or order a divestiture.⁹

Each of the countries we examined has a reviewing mechanism that differs in focus from CFIUS. Japan and France both have a formal process in which foreign investments are reviewed for several reasons, including public order, public safety, and national security. The United Kingdom and Germany have no general screening authority that explicitly considers national security issues related to foreign investment.¹⁰ However, as do many other nations, the United Kingdom and Germany have antitrust screening mechanisms. The United Kingdom, through its antitrust process, may make determinations based on harm to public interest. Germany's antitrust review mechanism does not screen for adverse impact on national security, but antitrust decisions against a merger may be overturned if the merger is considered to be in the public interest.

As shown in table 1, similarities and differences exist among the CFIUS process and selected reviewing mechanisms in Japan and France. For example, CFIUS and the other countries' reviewing entities are similar in that they perform case-by-case evaluations. These reviews have resulted in

⁸According to French government officials, none of the transactions were blocked for national security reasons. The French government blocked the transactions for public order reasons.

⁹The Exon-Florio regulations allow CFIUS to reopen its consideration of a transaction if parties fail to provide material information or submit false or misleading information.

¹⁰In one case involving the foreign acquisition of a German defense company, the German federal government established an ad hoc review committee to examine the terms of the transactions and possible national security implications.

few denied transactions based on national security concerns. However, significant differences exist among the reviewing mechanisms. Japan and France review foreign investments for national security and other reasons. While transactions are voluntarily notified to CFIUS, the two countries' reviewing mechanisms require mandatory notification for transactions meeting certain criteria. Also, Japan and France have a judicial appeal process, unlike the United States.

Table 1: Selected Countries' Foreign Investment Reviewing Mechanisms^a

Characteristics of reviewing mechanisms	United States	Japan	France ^b
Reason for reviewing	National security.	National security, public order, public safety, and economy.	Public order, health, or security; public functions; research, production, or trade in arms, ammunition, explosive powders and substances destined for military use or wartime equipment.
Reviewing body	CFIUS.	Ministry of Finance and Ministry in charge of industry.	Ministry of Economics and Finance, consulting with Ministries of Industry and Defense.
Notification	Voluntary.	Mandatory.	Mandatory.
Review time	Thirty-day review; 45-day investigation; 15-day presidential review for cases investigated.	Thirty days; can be extended up to 5 months.	Up to 1 month, unless postponement rights are exercised.
Judicial appeal	No.	Yes.	Yes.
Case-by-case evaluation	Yes.	Yes.	Yes.
Outcomes and time frame	Fifteen cases investigated since 1988; President blocked 1 case.	None since 1992 law revisions.	Eight rejected in 1992-93 and one in 1994 for public order reasons.

^aGermany and the United Kingdom are not included in the table because neither country has a foreign investment specific review mechanism that can consider national security implications.

^bThe French government changed its foreign investment law in February 1996 to abolish prior authorization of non-European investments meeting certain French franc thresholds. However, prior authorization is still required for all foreign investments in French entities carrying out public functions or activities that may affect public health, order, or security, or for investments involving research, production or trade in arms, ammunition, explosive powders and substances destined for military use or wartime equipment.

Source: GAO analysis.

Limitations Reported to OECD

All five countries impose some type of sectoral restrictions on foreign direct investment that are notified to OECD. For example, the five countries impose similar restrictions on maritime transport. OECD members also

report measures based on public order and essential security interests that are considered limitations to the National Treatment Instrument.¹¹ Of the five countries, only Germany reported no limitations for essential security interests. Table 2 shows the national treatment limitations that affect defense or national security-related areas in our selected countries.

Table 2: Selected Public Order and Essential Security-Related Measures Reported to OECD

Country	Foreign investment measures based on essential security considerations	Government purchasing measures based on essential security considerations	Other related measures
United States	The Exon-Florio legislation provides the President power to block foreign acquisitions that threaten to impair national security.	Foreign controlled enterprises may not be granted a contract or subcontract involving classified information, except under special arrangements determined on a case-by-case basis.	None.
Japan	Specific investment plans of foreign controlled enterprises could be altered or suspended when national security, public order, or public safety is deemed threatened in such industrial sectors as aircraft, arms, explosives, nuclear energy, and space.	None.	None.
France	National treatment is not applicable to enterprises whose activities are directly or indirectly related to national defense and armaments. The government reserves the right to apply conditions on the creation, extension, or conduct of business enterprises under foreign control or to obtain guarantees.	Preference is accorded to locally owned firms in procurement for the armed forces with regard to items for military purposes.	None.
Germany	None.	None.	None.
United Kingdom	British Aerospace PLC and Rolls Royce PLC restrict the number of foreign-held shares at any one time to 29.5 percent of the ordinary voting equity. The articles of association also provide citizenship requirements for the directors.	In a limited number of cases, foreign-controlled enterprises may not be granted defense procurement contracts where overriding security reasons apply.	Certain citizenship requirements for ex-Plessy companies engaged in classified work. VSEL Consortium PLC has citizenship requirements for certain executives. There is also a veto over disposal of company assets.

Source: National Treatment for Foreign Controlled Enterprises, OECD, 1993.

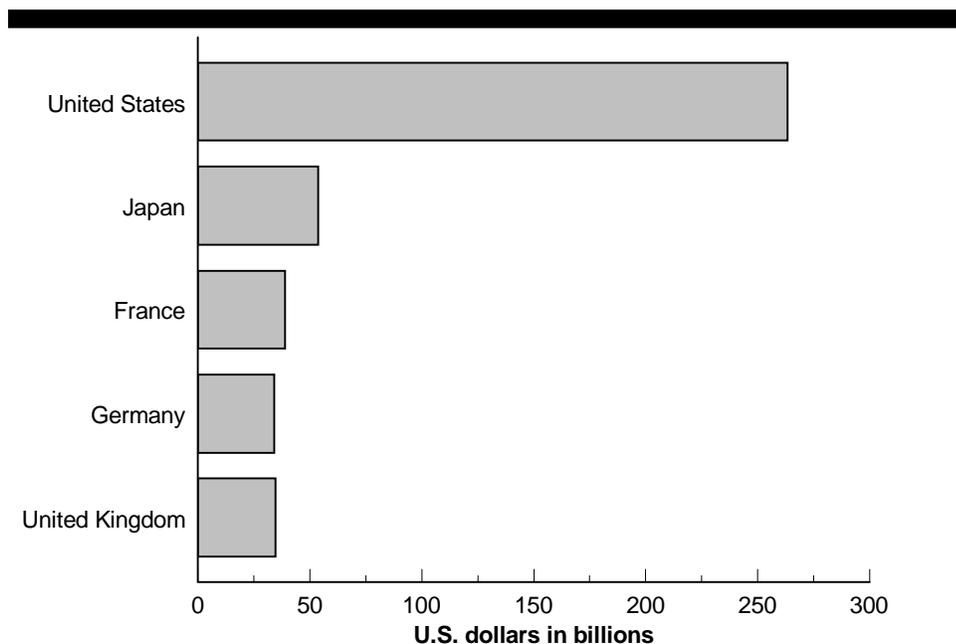
¹¹This instrument is a nonbinding agreement. It provides that OECD member countries will apply the same laws, regulations, and administrative practices to foreign-owned companies as would apply to domestic investors in like situations. Member countries must notify OECD of all measures constituting exceptions to this principle.

Economic Conditions and Informal Barriers Influence Investment Decisions

Fundamental economic conditions and informal barriers to doing business in the selected countries can be important determinants of whether U.S. firms pursue foreign direct investment options. Officials at many of the U.S. defense companies we interviewed were not planning to invest abroad because of the relatively small size of the countries' defense markets. They frequently cited basic economic factors and informal barriers, such as high land prices or domestic company ownership structures, as more important to their evaluation of investment options than the legal framework. Furthermore, the officials said that governments offer some incentives to invest, such as tax breaks, but these are not a significant factor in making investment decisions.

Some U.S. defense company officials we interviewed said the size of the defense markets in the four countries often did not justify major equity investments. For example, the German and British defense budgets are declining, which can make it less attractive for U.S. companies. Although the Japanese government has one of the larger defense budgets, it has a comparatively smaller equipment acquisition budget. As shown in figure 4, the U.S. defense budget was larger than those of the other countries reviewed.

Figure 4: Defense Budgets for Selected Countries, 1995^a



Source: The Military Balance, 1995-96, International Institute for Strategic Studies.

^aThe data is not adjusted for inflation.

U.S. defense and commercial companies are affected by the business environment overseas. In weighing decisions to invest abroad, U.S. company officials we interviewed said certain economic or social conditions can serve as disincentives. For example, companies established in France and Germany face strict labor practices and cannot lay off workers easily. In Japan, obstacles to doing business include labor costs, the tax burden, and high rent and land costs. Such factors make investment expensive and can affect the profit margins of established companies in these countries.

U.S. defense company officials we interviewed indicated company ownership structures can deter foreign direct investment. For example, extensive cross-shareholdings between businesses and large institutions exist in both Germany and Japan, which serve the long-term investment needs of domestic companies and discourage foreign investors. In France, the government has majority ownership of most of the major defense

companies and significant influence over other private defense-related companies. Unlike France, the United Kingdom has largely privatized most companies since 1979. However, the British government retains “golden shares,” or special consent rights, in certain privatized companies. This may include placing limits on foreign ownership as with British Aerospace PLC and Rolls Royce PLC.

Each of the countries has incentives to offer foreign investors, but these incentives played a limited role in influencing the investment decisions of the U.S. defense company officials we interviewed. Most of the countries offer some form of a tax incentive, low interest loan, or subsidy. Regional incentives exist to attract foreign investors to certain geographic areas. However, none of these investment incentives are defense specific.

Given the defense investment climate and economic conditions, many U.S. defense company officials we interviewed did not view foreign direct investment as an essential part of their strategy. However, some investments have been made. For example, General Electric and the French company, SNECMA, collaborated for over 20 years on the CFM-56 jet engine for commercial aircraft and established an equity joint venture in 1974 to supply propulsion systems. In 1993, BDM International, Inc., invested in the German company, IABG, which conducts aerospace testing and military and environmental studies.

Defense Companies Pursue Other Strategies to Gain Market Access

To gain market access, U.S. defense companies are largely seeking project-by-project business arrangements with European companies or selling in niche markets. These arrangements can be less expensive for U.S. companies to pursue compared to capital intensive equity investments. Some U.S. company officials said that having relationships with European partners is helpful because they offer knowledge of the regulatory environment. Successful partnerships include McDonnell Douglas and Westland Helicopters to produce Apache helicopters for the British Ministry of Defense. E-Systems joined with three German companies in developing the Senior Guardian recognizance program. Motorola, through a French distributor, sells certain electronic products in French niche markets, where the principal French defense electronics manufacturer Thomson-CSF is not present.

In contrast with the European business arrangements, U.S. defense companies export defense products and license technology from the United States rather than make capital investments in Japan. This strategy

is more advantageous to pursue because direct investment in Japan is expensive. For example, Hughes Aircraft is licensing its radar technology to a Japanese company for Japan's F-15s. Also, Japan has obtained technology and items from U.S. firms for the FS-X program.¹² The U.S. Department of State had approved over 500 FS-X munitions export licenses by March 1994. Most of these licenses covered hardware for the development and production of the prototype aircraft.

Agency Comments

The Departments of the Treasury, Commerce, State, and Defense and the Office of the United States Trade Representative generally agreed with our draft report and provided minor technical comments. The Department of Commerce, in official oral comments, said the draft report is an accurate and balanced representation of the facts. The Office of the United States Trade Representative, also in official oral comments, said that the report will be useful for the ongoing multilateral agreement on investment negotiations.

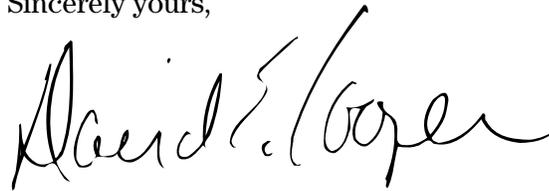
Officials from Japan, France, Germany, and the United Kingdom reviewed the appendix corresponding to their country. Most of these officials provided updated data or technical comments to the appendixes. We incorporated their comments where appropriate.

We are sending copies of this report to interested congressional committees and to the Secretaries of the Treasury, Commerce, State, and Defense; the United States Trade Representative; and the Director, Office of Management and Budget. We are also making copies available to other interested parties upon request.

¹²For more information on the FS-X program, see our report entitled U.S.-Japan Cooperative Development: Progress on the FS-X Program Enhances Japanese Aerospace Capabilities (GAO/NSIAD-95-145, Aug. 11, 1995).

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix VI.

Sincerely yours,

A handwritten signature in black ink, appearing to read "David E. Cooper". The signature is written in a cursive style with a large, sweeping initial "D".

David E. Cooper
Associate Director,
Defense Acquisition Issues

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Abbreviations

CFIUS	Committee on Foreign Investment in the United States
FECL	Foreign Exchange and Foreign Trade Control Law
MITI	Ministry of International Trade and Industry
OECD	Organization for Economic Cooperation and Development

Scope and Methodology

This report is a follow-on from our report that examined U.S. procedures for reviewing foreign investment in U.S. national security-related industries. We selected Japan, France, Germany, and the United Kingdom to review because these four countries reported most frequently to the Committee on Foreign Investment in the United States (CFIUS).

During our review, we interviewed many government officials. Within the U.S. government, we interviewed officials from the Departments of the Treasury, Commerce, State, and Defense; the Office of the U.S. Trade Representative; and U.S. embassies in Japan, France, Germany, and the United Kingdom. We also interviewed officials from the embassies of France, Germany, and the United Kingdom in Washington, D.C.. We also met with foreign government officials in the four countries, as follows:

- Japan
 - Ministry of Finance,
 - Ministry of International Trade and Industry, and
 - Ministry of Posts and Telecommunications.
- France
 - Ministry of Economics and Finance,
 - Ministry of Industry, and
 - Ministry of Defense.
- Germany
 - Ministry of Finance,
 - Ministry of Economics, and
 - Ministry of Defense.
- United Kingdom
 - Ministry of Trade and Industry,
 - Ministry of Defense, and
 - the Central Statistical Office.

While in France, we also interviewed officials from the Organization for Economic Cooperation and Development (OECD) and the U.S. Mission to OECD to discuss matters pertaining to various OECD instruments and the ongoing negotiations on the Multilateral Agreement on Investment. In addition, we interviewed officials at the European Commission and the U.S. Mission to the European Union in Belgium to obtain their views on European Union competencies in mergers and acquisitions and defense issues.

To compare the legal frameworks of the four countries with the U.S. Exon-Florio legislation, we reviewed (1) the laws in the original language,

(2) translations of the laws and regulations, or (3) summaries of the laws and regulations pertaining to foreign direct investment in each of the four countries. In addition, we discussed our understanding of the laws with the relevant government officials in each country. We also reviewed legal journal articles that addressed the same issues.

To obtain information on the regulatory framework and the barriers and incentives to investment and U.S. business activities in each country, we interviewed representatives from industry associations, chambers of commerce, research and educational institutions, and U.S. and foreign embassies. We also interviewed officials from 20 U.S. companies that sell defense-related products and officials from the North Atlantic Treaty Organization and the Western European Union about opportunities for U.S. defense companies to invest in Europe. We also conducted literature searches for relevant information and reviewed documents from various representatives and officials.

Our work was limited in two ways. First, we did not select a random sample of companies; instead, we selected companies on the basis of the type of business investment and the willingness of company officials to speak with us. Therefore, we cannot make any statistically significant conclusions based on our interviews. Second, we could not obtain data concerning the number of U.S. direct investments in the defense industries of these countries because U.S. government sources gather the data according to industrial categories in which defense is subsumed. Instead, we obtained defense investment data from the Center for Strategic and Budgetary Assessments, which maintains a globalization database that contains over 1,050 entries on international collaborative arms activities, including defense mergers, acquisitions, and joint ventures. We did not verify the information in the database.

We conducted our review between March and December 1995 in accordance with generally accepted government auditing standards.

Japan

Japan's Foreign Exchange and Foreign Trade Control Law (FECL) is the primary law pertaining to foreign direct investment and provides the authority to block or restructure an investment. This law requires prior notification of a proposed investment in certain industries so that the Ministry of Finance and other ministries may review the proposed investment to determine whether the investment might adversely affect national security, public order, public safety, or the Japanese economy. This authority, however, has not been used at least since 1992 because (1) foreign investors informally consult with the ministries before formal notification and (2) the ministries use administrative guidance¹ to affect any potential investments. Indirect barriers and economic conditions, such as the structure of Japan's defense industry and the high cost of doing business in Japan, discourage foreign investment in Japan, rather than Japanese legal restrictions. Instead of foreign direct investment, U.S. defense companies prefer to license technology to Japanese companies or export directly to Japan.

Background

Foreign direct investment in Japan is small compared to investment in the other countries we reviewed. Japan received about 0.7 percent of all OECD foreign direct investment inflows from 1971 to 1990, even though Japan's economy is the second largest in the world. Japan's largest investor is the United States, which accounted for 42 percent of all foreign direct investment in Japan by the end of March 1992. However, the dollar value of U.S. direct investment in Japan is small compared to Japanese direct investment in the United States. As of 1994, U.S. direct investment in Japan reached \$37 billion, whereas Japanese direct investment in the United States reached \$103.1 billion, according to the U.S. Department of Commerce.²

Japan's overall defense budget is not declining, unlike most other major economic powers. Japan's defense budget has been growing for the past 5 years, although at a steadily decreasing rate. The budget increased in real terms 3.8 percent between 1990 and 1991, but by 1994, the budget increased 0.9 percent from the 1993 level. However, Japan's defense acquisition budget has been declining for several years. From fiscal year

¹Administrative guidance refers to the suggestions or "unwritten orders" given by Japanese government officials to firms to implement official policies. It is based on the broad discretionary power of the bureaucracy rather than on specific laws.

²Some experts argue that U.S. investments in Japan are undervalued. Nonetheless, they agree that U.S. investments in Japan are much smaller than Japanese investments in the United States.

1991³ until fiscal year 1994, Japan's acquisition expenditures fell 17.9 percent. As Japan's defense industry depends on sales to the Japan Defense Agency, the industry is experiencing economic difficulty. The Japan Defense Agency stated in a 1994 report that the defense industry is in a harsh environment because of the declining acquisition expenditures and economic depression.

Japan's defense industry plays a small role in its economy, accounting for about 0.6 percent of Japan's total industrial production. Defense contracts are heavily concentrated among a few companies. In fact, the top 10 defense contractors account for about 60 percent of total expenditures. However, even among the top defense contractors, defense-related sales account for a small percentage of total sales compared to U.S. defense companies.

Legal Framework Exists for Reviewing and Blocking Foreign Investments

As Japan's primary law concerning foreign direct investment, FECL provides that the ministries may advise or order an investor to either restructure or suspend a proposed investment if they determine that the investment may harm national security, public order, public safety, or the economy. However, the Japanese government has not used this authority at least since FECL was amended in 1992, according to Japanese government officials. Industry observers indicated that the ministries are commonly consulted by companies or their legal representatives to obtain informal approval prior to official notification. Ministry officials stressed that this consultation is optional. Nonetheless, the ministries have the opportunity to influence investment decisions prior to formal notification through these consultations or by administrative guidance, according to foreign company representatives and members of academia.

FECL provides a broad definition of foreign direct investment. FECL defines foreign investment as (1) having at least 10 percent foreign ownership of shares in a company listed on a Japanese stock exchange; (2) having foreign ownership of any shares in an unlisted company; (3) establishing a branch, factory, or other business office in Japan; (4) consenting to change the corporate objectives of a domestic company with one-third or more foreign ownership; or (5) lending certain types of money to domestic companies.

³Japan's fiscal year begins on April 1 of that calendar year and ends on March 31 of the following calendar year.

Notification Procedures

FECL and its implementing documents require reporting or notification of all foreign direct investment in Japan. The law provides for ex post facto, or “after the fact,” reporting for investments in most industries, which are identified in a public notice. A foreign investor must file a report with the Ministry of Finance and the ministry with jurisdiction over the industry through the Bank of Japan within 15 days after a transaction occurs. Ministry of International Trade and Industry (MITI) officials stated that the reason for ex post facto reporting was for statistical purposes and in case of an emergency, such as a financial crisis or war.

The law requires prior notification for exceptional cases, in which foreign direct domestic investment is proposed (1) by an investor from a country not listed in the public notice and for which Japan has reciprocity concerns and (2) in an industry not listed in the public notice. The public notice excludes industries relating to national security, public order, or public safety, as well as industries reserved by Japan under the OECD Code of Liberalization of Capital Movements. Failure to notify the ministries can result in jail time and/or a monetary fine.

FECL authorizes the Ministry of Finance and the ministries of jurisdiction to review for national security and economic reasons any proposed investments in industries requiring prior notification. The law provides ministerial review to determine whether the proposed investments might (1) imperil the national security or disturb the maintenance of public order or public safety or (2) adversely and seriously affect the Japanese economy. Sectors that require prior notification include aircraft and aircraft parts, explosives and munitions, atomic power, space development, and certain types of telecommunications.

Japan also requires prior notification of investments in sectors reserved through the OECD Code of Liberalization of Capital Movements. Under the OECD code, Japan reserves the following industries: agriculture, forestry and fisheries; mining; oil; leather and leather products manufacturing; air transport; and maritime transport. A Ministry of Finance official stated that these industries are reviewed mainly for economic reasons, although some are also reviewed for national security reasons.

The Review Process

Ministerial reviews may extend from 30 days to 5 months. The ministries have 30 days to review a proposed investment after a foreign company has notified the ministries of its intent to invest. If the investor has not received a response within that time, the transaction may be completed,

according to MITI officials. The ministries may extend the review period for up to 4 months if they believe further inquiry is necessary. A Committee on Foreign Exchange and Other Transactions also may extend the review period an additional month.⁴ However, a Finance Ministry official stated that the review period usually is less than 30 days.

FECL and its related documents do not provide criteria to determine whether a proposed investment will pose a national security or economic threat. The ministries review investments on a case-by-case basis and therefore apply no set standards, according to MITI officials. The notification form requires information concerning the percentage of shares to be acquired, the business plan of the investing company, and the reason for the transaction. However, the ministries may consider information related to foreign control, such as the number of foreign board members and the foreign company's reputation, according to Japanese government officials.

Investors may appeal the decision of the ministries. FECL provides for a public hearing if an investor wishes to contest the result of the ministerial review. After the public hearing, an investor may appeal to the Japanese courts to try to overturn a decision.

Economic Factors and Indirect Barriers Inhibit Investment

Economic factors and indirect barriers, rather than Japanese laws, appear to be the primary determinants of foreign investment across sectors. The U.S. company representatives that we interviewed stated that they have encountered no legal barriers to foreign investment in Japan in recent years. An American Chamber of Commerce in Japan report also indicates that legal barriers to investment in Japan have been removed.

The nature of Japan's defense industry acts as a deterrent to foreign investment in that sector. Japan's market for defense items is considered by many observers to be too small to warrant the expense of establishing facilities in Japan. Establishing manufacturing facilities in Japan would be too costly and, according to one U.S. defense company official, would take away from economies of scale achieved at U.S. production facilities. Japan's defense market has primarily one client, the Japan Defense Agency, because the Japanese government basically prohibits exporting defense items to third countries. While the Japan Defense Agency has one of the larger defense budgets in the world, only 18.4 percent was devoted

⁴The committee is appointed by the Minister of Finance to provide an opinion on direct investment and other matters.

to equipment acquisition in fiscal year 1995. Furthermore, the Japan Defense Agency's preference for domestic procurement of defense items and the prohibition on arms exports increases the acquisition costs because of the high per unit cost of small production runs. As a result, the acquisition budget buys fewer items.

The size and structure of Japanese companies that produce defense items also discourage U.S. defense companies from attempting to purchase a controlling share in these companies. Japan has few companies dedicated solely to defense production. Most of the Japan Defense Agency's defense purchases are from huge Japanese conglomerates, such as Mitsubishi Heavy Industries, Kawasaki Heavy Industries, and Fuji Heavy Industries. However, defense sales provide a small percentage of sales for these companies compared to U.S. defense companies. For example, defense-related sales account for about 13 percent of Mitsubishi Heavy Industries' total sales, even though the company is the Japan Defense Agency's top defense contractor and is ranked as 1 of the top 20 defense companies worldwide. Furthermore, U.S. company officials stated that the size of a "heavy" makes it too expensive to try to buy a controlling portion of one. Some U.S. company officials stated that, even if they wanted to acquire a Japanese company that does defense work, the Japanese government would discourage such action.

Across sectors, business practices, structural barriers, and economic factors are frequently cited as major obstacles to investment. For example, a study commissioned by the American Chamber of Commerce in Japan and the Council of the European Business Community cited selective enforcement of regulations as one of the main barriers to doing business in Japan. Many of the representatives of U.S. defense companies we interviewed, as well as numerous studies, stated that the high cost of doing business in Japan, including labor costs, the tax burden, rent and land costs, and regulatory issues, is a disincentive to investment. Foreign acquisitions of Japanese companies face barriers caused by cross-shareholding—the practice of companies holding shares of each other's stock—and *keiretsu* relationships—groups of affiliated companies in related or unrelated fields that hold each other's shares and may also have financial (such as bank loans) or manufacturer-supplier ties or distributor relationships. Cross-shareholding and *keiretsu* relationships lessen the amount of shares available to buy on the stock market. In addition, cross-shareholding may prevent a foreign company from taking management control of a company, even if the foreign company is the largest individual shareholder. The relationships among *keiretsu* members

make it difficult for foreign companies to buy into a member company and also to sell products to members of the *keiretsu*.⁵

Recent bilateral discussions between the U.S. and Japanese governments have addressed some of the barriers to U.S. investment in Japan. The resulting agreement, which was signed in July 1995, detailed actions that the Japanese government has recently taken and outlined criteria for assessing the effectiveness of these actions. In addition, the Japanese government has pledged to promote foreign investment into Japan.

Incentives Have Little Impact on Investment Decisions

The Japanese government offers a variety of incentives to encourage foreign direct investment. The Law on Extraordinary Measures for the Promotion of Imports and the Facilitation of Foreign Direct Investment in Japan provides for tax incentives and loan guarantees for eligible foreign companies.⁶ For example, the law provides for (1) accelerated depreciation of buildings, machinery, and equipment; (2) extension of the carry-over period to 7 years for losses incurred during the first 3 years of starting business in Japan;⁷ and (3) exemption from special local land-holding taxes if certain conditions are met. The law also provides for loan guarantees for acquiring facilities and equipment. In addition to the special measures provided by the law, both Japanese national and prefectural governments offer incentives, such as tax incentives, subsidies, low-interest loans, and loan guarantees.

Some U.S. companies have used these incentive programs. However, the company and industry representatives that we interviewed were unimpressed with the benefits provided by the incentives. Also, the 1995 survey by the American Chamber of Commerce in Japan and the European Business Council indicated that survey respondents viewed these incentives neither positively nor negatively. One company representative stated that the incentives were of no real benefit because the paperwork requirements for the incentive programs were onerous.

⁵For further discussion of the Japanese business environment and some indirect barriers to investment, see *Competitiveness Issues: The Business Environment in the United States, Japan, and Germany* (GAO/GGD-93-124, Aug. 9, 1993).

⁶This law has been extended until 2006.

⁷Effective fiscal year 1996, companies may carry over losses incurred during the first 5 years, rather than 3 years.

**U.S. Companies
Obtain Access to
Japan's Defense
Market Through
Approaches Other
Than Direct
Investment**

Few, if any, U.S. companies have invested in Japan's defense industry, according to U.S. company, industry association, and Japanese government officials we interviewed. U.S. defense company officials have indicated that the decision not to invest in Japanese businesses is not based on Japan's regulatory environment, but on economic reasons. Instead, U.S. companies have realized sales to Japan through exporting from the United States and licensing technology, making the expense of investing in Japan unnecessary. Many U.S. companies have established branch or representative offices to facilitate these activities in Japan but do not have manufacturing facilities. When U.S. firms that have defense contracts in the United States have established either joint ventures or 100 percent-owned subsidiaries in Japan, these firms target the consumer market, not defense.

France

The French foreign investment law requires prior approval of foreign direct investment in sectors that affect public functions, public order, health, security, or aspects of the defense industry but certain prior authorization requirements were recently liberalized.¹ The French Ministry of Economics and Finance has the authority to block foreign investments made without proper authorization. The Ministry consults with the Ministry of Defense in cases concerning investment in national security-related industries. To date, Ministry officials are unaware of any proposed investments by U.S. companies that were denied on national security grounds in recent years. Nonetheless, few of the major French defense companies are available for U.S. companies to acquire because most are owned by the French government. U.S. companies prefer teaming with French companies on a project-by-project basis to achieve defense sales in France.

Background

France is one of the main host countries for foreign direct investment among OECD nations. France has received over \$87 billion in foreign direct investment, cumulatively from 1971 through 1992. About 30 percent of the French economy is owned by foreign investors. U.S. foreign direct investment in France reached almost \$27.9 billion and French foreign direct investment in the United States reached almost \$33.5 billion in 1994, according to the U.S. Department of Commerce. U.S. investments represent about 36 percent of total sales by foreign-owned subsidiaries in France. The French government characterizes much of the U.S. investment in France as occurring in high growth, high technology areas.

The French defense budget has declined slightly in real terms during the past 5 years. From 1990 to 1994, the French defense budget declined 4 percent after adjusting for inflation. In addition, the French government reduced its 1995 defense budget to \$38.86 billion following a \$1.7-billion cut in procurement. The French government strongly supports its defense industrial base and obtains nearly 90 percent of its defense equipment from French companies. However, according to a French government official, the Ministry of Defense plans to increase the percentage of the budget devoted to cooperative efforts.

¹A new French law and decree on foreign investment was enacted in February 1996.

Legal Framework Exists for Reviewing Foreign Direct Investment

French law requires prior authorization from the French Ministry of Economics and Finance for foreign investments concerning (1) public functions, (2) public order, health, or security, or (3) research, production or trade in arms, ammunition, explosive powders and substances destined for military use or wartime equipment.² The Ministry of Economics and Finance has the authority to block foreign investment in these areas made without proper authorization. Ministry of Economics and Finance officials were unaware of any proposed U.S. investments being denied approval in recent years. However, the French government blocked eight transactions by non-U.S. companies in 1992 and 1993 and one in 1994 on public order grounds.

French law defines foreign direct investment as (1) the purchase, establishment, or expansion of a business or branch or (2) any other transactions that enable nonresidents to acquire or increase control over a company engaged in industry, commerce, agriculture, finance, or real estate. It also generally defines foreign control as occurring when at least 20 percent of a company's shares are owned by nonresidents or by companies under the control of nonresidents. However, other factors may be considered when determining foreign control, such as whether loans, commercial ties, or licensing arrangements result in additional control by a foreign entity. A company not listed on the stock exchange is considered under foreign control when at least 33.33 percent of its voting rights are owned by nonresidents.

Notification/Authorization Procedures

Foreign investors must notify the French Ministry of Economics and Finance of the intent to invest in sectors relating to government functions; public health, safety, or order; or defense. The government has up to 1 month in which to respond. If the government does not respond, the investment is presumed to be approved, unless the Ministry of Economics and Finance exercises its right of postponement. Any investor who has failed to file the prior notification or to obtain the required prior authorization is subject to a fine. The Minister of Economics and Finance is able to annul an investment that would have been denied if the procedures had been observed.

Until recently, French law made a distinction between European Union and non-European Union investors in sectors not related to national security, public health, safety, or order. Specifically, European Union

²Certain foreign business transactions in these sectors will not be subject to the notification or approval process. These include greenfield investments and increased foreign control in businesses that are already at least 66.66 percent foreign controlled in terms of capital and voting rights.

investors were not required to obtain prior approval when acquiring a controlling interest in a French company. However, such approval was required for non-European Union investors acquiring a controlling interest in any French company if the assets were worth at least 50 million French francs or had annual sales of at least 500 million French francs. In February 1996, the French government enacted legislation eliminating this prior authorization requirement for non-European investors. Under the new law, all investors are required to submit administrative notification to the French government when the investment is made. This notification is required for statistical purposes and to verify that the transaction has taken place.

The French government's investment approval process is headed by the Ministry of Economics and Finance. However, the Ministry of Economics and Finance consults with the Ministry of Industry on all transactions and with the Ministry of Defense if there is a national security concern. The Ministry of Defense is responsible for monitoring industry structures to ensure that strategic defense-related supplies are not excessively concentrated in foreign-controlled sources, when these sources are less reliable. Typically, sectors relating to national security could include dual-use sectors such as chemicals and electronics, as well as production of weapons. Ministry of Economics and Finance officials were not aware of any recent cases in which the Ministry of Defense advised against approving an acquisition by a foreign investor.

French law does not provide criteria for evaluating a proposed acquisition. Furthermore, if the French government were not in favor of a proposed acquisition, it could negotiate with investors informally. Foreign investors have the right to appeal French government decisions in court, but in practice that right is not exercised. U.S. embassy officials stated that U.S. companies may be reluctant to appeal decisions to avoid the risk of impairing future business ventures in France.

Other Limitations on Foreign Investment

France maintains restrictions on foreign investment activity in certain sectors of the economy. Under the OECD Code of Liberalization of Capital Movements, France reserves the right to restrict foreign investment in air transport, maritime transport, and insurance. In addition, France takes exceptions to the OECD National Treatment Instrument in the following areas: agriculture, air transport, broadcasting, insurance, maritime transport, publishing, road transport, telecommunications, and tourism. In the national security-related sectors, the French government reserves the

right to restrict the creation, expansion, or operation of foreign-controlled aerospace companies. Furthermore, foreign-controlled defense companies are not entitled to national treatment in defense procurement by the French government.

Indirect Barriers Hinder Foreign Direct Investment

In general, the approval process for foreign investment is not considered a significant barrier to foreign investment. Officials from the U.S. Embassy in Paris stated that they have not received complaints from U.S. companies since 1990 and that there have been no major investment disputes since 1984. Indirect barriers to investment appear to inhibit foreign investment.

French government ownership of a company can inhibit foreign investment. The French government has majority ownership of most of France's major defense companies, as noted in table III.1. As a result, controlling shares are not available for foreign companies to purchase. French defense companies were included in the 1993 privatization law, but these companies have yet to be privatized. In the event of privatization, French law prohibits the French government from selling more than 20 percent equity to non-European Union investors during the first share offering to the public.³ Subsequently, private investors may resell their shares to non-European Union investors. After privatization, the French government can control a strategically important company through a "golden share."⁴ Application of this measure has remained limited, since few of the major French defense companies are privatized.

³In this case, the law becomes a formal barrier to foreign direct investment. However, French government officials said that this restriction on non-European investors may be repealed.

⁴This share accords the French government special rights of control in a privatized company.

**Appendix III
France**

Table III.1: French Defense Company Revenues and Ownership as of 1993 (dollars in billions)

Company name	1993 revenue	Ownership
Thomson-CSF ^a	\$4	State controlled: 60% Thomson SA, which is state-owned
DCN	3	State controlled: 100% Ministry of Defense
Dassault ^b	2	State controlled: 46% French government; 50% Dassault family
Aerospatiale ^b	2	State controlled: 80% French government; 20% Credit Lyonnais ^c
CEA	2	State controlled: 100% French government
GIAT	1	State controlled: 100% French government
Eurocopter	1	State controlled: 70% Aerospatiale; 30% Daimler-Benz
Matra	1	Privately owned (State controlled 1981-87)
SNECMA	0.8	State controlled: 97% French government
Sextant	0.7	State controlled: 66% Thomson-CSF; 33% Aerospatiale

^aThe French government announced that it would privatize Thomson-CSF by the end of 1996.

^bAccording to French government officials, Dassault Aviation is expected to merge with Aerospatiale within 2 years.

^cThe French government has majority ownership of Credit Lyonnais.

Overcapacity and restrictive labor practices serve as disincentives to foreign investment in French defense companies. Reducing current overcapacity in French defense companies would require massive layoffs. French law provides workers with extensive compensation packages in the event of layoffs. As a result, several U.S. company officials stated that they did not see the possibility of sufficient returns through investing in French defense companies.

Across sectors, cross-shareholding among French corporations and close relationships among French company and government officials can make it difficult for foreign investors to acquire French companies. Often two or more French companies will hold shares of each other's stock, thus providing a pool of stable shareholders. According to a U.S. embassy report,⁵ the practice of cross-shareholding arose from the French government owning most large banks and insurance companies in the past. The French government used the banks and insurance companies to invest in other companies as a way of controlling other firms. In addition to cross-shareholding, many French company officials have close personal

⁵Investment Climate in France, FY95, U.S. Embassy Paris.

relationships with government officials. Most top French company and government officials are alumni of the same universities. In addition, many top French company executives sit on each others' board of directors.

Incentives Are Not Attractive to U.S. Defense Companies

The French government offers investment incentives that are based on the proposed investment's contribution to regional development, particularly in terms of job creation and development of the technology base. Accordingly, the French government created the Delegation for Land Use and Regional Incentives, which provides financial investment incentives, such as grants, loans, tax credits, and support for research and development. French national and local governments particularly provide incentives to encourage start-up businesses that will create new jobs. However, French ministerial officials acknowledge that these incentives alone may not be large enough to attract U.S. defense companies.

Teaming Arrangements Are an Alternative to Foreign Direct Investment

U.S. defense companies generally are not interested in investing in France to achieve defense sales. General Electric and SNECMA have collaborated for over 20 years on the CFM-56 jet engine for commercial aircraft, and they formed a joint venture company in 1974 to supply propulsion systems. U.S. firms typically either sell in niche markets in which French firms do not compete or team with French firms on a project-by-project basis to sell to the Ministry of Defense.

U.S. companies benefit from teaming with French defense companies because the chances of selling to the French Ministry of Defense are greater. Since the French government is subsidizing overcapacity in its defense industry, it is unlikely to award prime contracts for major equipment procurement to a foreign contractor. Furthermore, French companies maintain close contacts with Ministry of Defense officials and understand the French defense procurement process.

Germany

The Federal Republic of Germany has the legal authority to restrict foreign direct investment in its national security-related industries, but it has no administrative controls, bodies, or practices that overtly monitor, screen, track, or otherwise restrict such investments. Restrictions on foreign ownership are limited to a few nondefense-related sectors and public monopolies. While U.S. defense company officials identified disincentives to investment in the defense sector, they indicated that they pursue market access to Germany through project-by-project teaming arrangements rather than through mergers or acquisitions.

Background

Germany is one of the largest U.S. trading partners in Europe. The United States is the largest single investor in Germany, accounting for over 27 percent of its foreign direct investment by the end of 1992. The United States invested about \$1.6 billion in Germany in 1992, and Germany invested almost \$1.4 billion in the United States in 1992, according to OECD. By the end of 1994, total U.S. direct investment in Germany was about \$39.9 billion, and total German investment in the United States equalled about \$39.6 billion, according to the U.S. Department of Commerce. While Germany exported about \$6.2 billion worth of arms between 1987 and 1991, its defense industry is of relatively minor importance for the economy as a whole. German arms exports and imports accounted for no more than 0.8 percent and 0.3 percent of total exports and imports, respectively, in the 1980s.

Germany historically has depended upon the United States and other countries for many of its security needs through cooperation with the North Atlantic Treaty Organization. Furthermore, the United States remains the largest seller of defense items to Germany; almost 74 percent of Germany's defense imports worth \$2.6 billion came from the United States between 1985 and 1989. However, German military procurement has declined about 48 percent from 1990 to 1995.

Legal Authority, but No Framework Exists for Restricting Foreign Direct Investment

Germany retains the authority to regulate and/or restrict foreign investment on the basis of national security, but it has never used that authority. The German Foreign Trade Law gives the government the power to restrict foreign direct investment for reasons of national security, public order, foreign policy, and balance of trade considerations. However, to date, the government has never imposed restrictions on foreign direct investment for reasons of national security. The 1956 Treaty of Friendship, Commerce and Navigation between the United States and Germany

recognized the German government's authority to take such actions necessary to protect its national security interest. This authority would allow the German government to prohibit foreign direct investment by U.S. firms for national security reasons, but that authority has never been invoked.

Germany has no other administrative controls, bodies, or practices that restrict foreign investment in its national security-related industries. German officials stated that their government neither screens nor tracks foreign direct investment in German national security-related industries. U.S. government analyses concur with this assessment.

The German government's Federal Cartel Office has the authority to review mergers and acquisitions, including foreign direct investment, for violations of German antitrust laws. However, the Cartel Office, an independent government agency that administers German antitrust laws, does not screen for adverse impact to national security. If the Cartel Office prohibited a proposed merger on the grounds it would have a detrimental impact on competition, the Minister of Economics could override the Cartel Office's decision if it deemed the merger to be in the public interest. Public interest can include job preservation or military necessity.

Germany imposes no limitations on national treatment for foreign investors in the national security-related sectors or other sectors. Germany extends national treatment to any foreign firm that establishes itself in Germany, whether or not it is in the national security-related sector. Under German law, any foreign firm registered as a limited liability company (GmbH) or a joint stock company (AG) is regarded as a domestic company. It also imposes no currency or administrative controls on foreign direct investment.

Germany generally allows 100 percent foreign ownership of any company within the country, except for a few sectors. Germany reserves the right to restrict investment in air transport, maritime transport, and broadcasting under the OECD Code of Liberalization of Capital Movements. Germany also takes exceptions to the OECD National Treatment Instrument for foreign investment in air and maritime transport. OECD reported that Germany has no other informal measures that may impede foreign investment.

Germany Lacks a Self-Sufficient Defense Industry to Protect From Foreign Investors

German and U.S. officials stated that historical and economic factors account for Germany's lack of restrictions on foreign investment in its defense industrial sector. Germany has accepted its dependence on the United States and the other North Atlantic Treaty Organization nations for its national security. Moreover, Germany has always been economically more dependent on outside sources for its supply of strategic minerals and fuels than the United States, according to one Ministry of Finance official.

The post-war German defense industry has also been open to foreign collaboration and investment because it has never been self-sufficient. Germany, unlike the United States or France, does not have a great power status to preserve through protecting a self-sufficient defense industrial base, according to a U.S. government official. A Ministry of Defense official concurred, estimating that about 70 percent of Germany's military weapon systems are made in cooperation with other countries. Furthermore, Germany does not limit foreign direct investment through any defense industrial base policies or economic security policies.

Security and Industrial Base Concerns Raised in Foreign Acquisition

German and U.S. officials know of only one case where national security-related concerns were raised in an unsuccessful attempt to block the acquisition of a German firm by a U.S. defense company. The German government organized a review team headed by the Ministry of Finance to examine the proposed sale's terms and the U.S. company's ties to the U.S. government. Both German and U.S. officials stressed that this was an ad-hoc procedure, on a one-time basis. The Ministry of Defense was one of the first agencies to approve the sale. The Ministry of Defense had been subsidizing the German company at a loss and wanted to privatize it, according to a U.S. defense company official.

The German federal government approved of the sale, but others tried to block it. Members of the Bundestag (Federal Parliament) and German defense companies that were organizing a consortium to buy the company objected on the grounds that the United States would obtain German defense secrets. The French government also objected to a U.S. company testing sensitive technology that the German company and French companies shared through cooperative projects. Furthermore, the state government objected to the potential loss of high-technology jobs within the German state and pressured the federal government to reverse its decision.

In response to these objections, the U.S. company modified its acquisition offer and attained a significant minority share in the German firm. It also worked out arrangements with the federal government to safeguard both sensitive defense data and German jobs. For example, the federal government agreed to establish a Defense Oversight Board consisting of personnel from the Ministry of Defense and the German company to review security procedures and determine whether there are problems with foreign influence and control to be resolved.

Economic Factors and Government Requirements Impede Investment in National Security-Related Industries

U.S. government and company officials we interviewed cited both economic factors and German government requirements as disincentives to invest in Germany's national security-related industries. Germany's high labor costs and tax rates can limit foreign direct investment. Moreover, Germany's strict business regulations give the government authority over both foreign and domestic companies. Companies established in Germany face rigid labor practices; they cannot lay off workers easily and cannot move or alter facilities without government permission. This tight control of the business environment constitutes more of an investment disincentive than any government body or screening practice, according to one U.S. official.

German business relationships and corporate structure also inhibit foreign direct investment. The close and long-term business relationships German firms maintain with their suppliers are difficult for foreign firms to penetrate. In addition, German corporations have interlocking relationships with banks that make it difficult for outsiders to invest. In 1988, banks and insurance companies owned more than 20 percent of Germany's publicly traded companies.¹

U.S. government and defense company officials cite the unfavorable investment climate in Germany as reasons not to invest. The declining German defense budget and the relatively low rates of return on investment in the shrinking European defense sector are among the most important factors influencing investment decisions.

German export controls, procurement regulations, and classified information security procedures can also pose barriers to investment in the defense sector, according to U.S. defense company officials. German conventional weapon export controls have become particularly strict

¹For further information on the German business environment, see *Competitiveness Issues: The Business Environment in the United States, Japan, and Germany* (GAO/GGD-93-124, Aug. 9, 1993).

recently. German procurement regulations are complicated and difficult to understand, according to some U.S. company officials. One German industry representative pointed out, however, that every country has such regulations that give an advantage to the domestic firms most familiar with them.

Germany's classified information security procedures were mentioned as a possible barrier to investment, but these procedures were also characterized as less rigorous in comparison to those of other countries. According to a German official, the Ministry of Economics is not concerned about foreign ownership of German defense companies. The government maintains control of classified materials and information through an "access check" of prospective buyers performed by the Ministry of Economics. In this official's view, these checks present no problems to firms from the North Atlantic Treaty Organization countries.

Incentives to Invest Are Too Limited to Attract U.S. Defense Companies

Germany encourages foreign direct investment in all economic sectors, including its defense industry, and grants national treatment to all foreign companies. Germany places no restrictions on foreign companies seeking access to state-funded research and development funds and other incentive programs. A U.S. embassy document states that U.S. companies legally established in Germany are eligible for research and development technology funds from the German federal government. Moreover, German ministries pursue the involvement of foreign-based companies to facilitate international cooperation. However, U.S. government and defense company officials and German industry representatives indicated that the research and development subsidies are generally too limited to attract U.S. defense firms.

The German government allotted \$12 billion for civilian research and development in 1993, according to U.S. embassy figures. The incentives are concentrated in basic and applied sciences, aerospace technology, energy research and development, and information technology. U.S.-affiliated firms are also eligible to participate in the Ministry of Research and Technology's priority "Technologies of the 21st Century" programs, such as artificial intelligence and sensor technology. While no formal barriers exist to U.S. affiliates' participation in these programs, few make use of these programs either in the national security-related sector or in other sectors. A State Department document reported that U.S. companies participate in only 8 of approximately 6,000 federally funded projects. Moreover, a Department of Commerce report estimates that

Germany awards approximately 85 percent of total military spending (including research and development, procurement, and maintenance spending) to domestic firms.

**U.S. Defense
Companies Use Other
Means to Obtain
Market Access in
Germany**

U.S. defense company representatives and embassy officials in Germany stated that U.S. defense firms seek market access through cooperative ventures with German firms on a project-by-project basis rather than pursue longer term direct investment in Germany. Most of the U.S. defense companies we contacted use this approach, including one company that has acquired a small German defense-related firm.

Some company representatives stated that their U.S.-produced goods remain sufficiently competitive to generate sales in niche markets (i.e., fulfill a German demand for subsystems they lack the capability to produce themselves). They stated that to successfully compete, U.S. firms enter partnerships with German firms to allow German participation, gain influence with the German government, and acquire knowledge of the procurement process through their German partners.

United Kingdom

British law provides no legal framework specifically designed to monitor foreign direct investment for national security reasons. However, the U.K. government has the authority to block or restructure takeovers of U.K. companies by foreign or domestic companies for national or public interest reasons. The United Kingdom restricts foreign direct investment in certain sectors of the economy, which are registered under the OECD Code of Liberalization of Capital Movements. Also, the government retains a special share in key privatized companies, which in some cases limits foreign ownership and also accords certain veto powers to the government. U.S. company officials in the United Kingdom believe that the legal and regulatory climate presents no obstacle to investments and that U.S. defense firms are more likely to enter into teaming relationships with U.K. companies rather than engage in mergers or acquisitions.

Background

Overall foreign direct investment in the United Kingdom has increased significantly over a 15-year period. Foreign direct investment in the United Kingdom has risen from \$28 billion in 1978 to over \$195 billion by the end of 1993. The United States is the largest foreign investor in the United Kingdom. U.S. foreign direct investment in the United Kingdom reached about \$102.2 billion in 1994, according to U.S. Department of Commerce figures. U.S. firms have established some 4,200 branches, subsidiaries, and affiliates in the United Kingdom, while German and Japanese firms each have established over 1,000 entities. U.S. investments in the United Kingdom represented 43 percent of all its investments in the European community by year end 1993. The United Kingdom had the largest share of foreign direct investment in the United States in 1992, accounting for 37 percent of its total foreign direct investment abroad. By comparison, the other European Union countries combined account for 26 percent of all foreign direct investment in the United States. U.K. foreign direct investment in the United States reached about \$113.5 billion by 1994.

The U.K. defense budget has declined some 25 percent in real terms over the past 10 years, prompting significant consolidation of the defense industry. Defense spending in the United Kingdom is expected to decline by around 14.5 percent between 1992-93 and 1997-98, but the U.K.'s defense expenditures remain above those of other European North Atlantic Treaty Organization countries.

Legal Framework Can Consider National Security Issues

The United Kingdom has no general notification requirements that specifically govern all forms of foreign investment. The Industry Act of 1975 provides the U.K. government with the authority to intervene when the takeover of important manufacturing concerns by nonresidents is against the national interest. The law does not define the term “important.” However, manufacturing industries are defined under the Standard Industrial Classification Orders and include defense-related sectors such as ordnance and aerospace equipment manufacturing. The U.K. government has never used the authority provided under this act.

The Fair Trading Act of 1973 provides an anticompetitive review of both foreign and domestic mergers and acquisitions. The act includes provisions permitting review of transactions that meet a certain threshold¹ for adverse effect on competition and the public interest. The Director General of Fair Trading initially performs the review and advises the Secretary of State for Trade and Industry whether the merger or acquisition should be investigated further by the Monopolies and Mergers Commission, an independent body. Under the law, the Secretary of State for Trade and Industry has the authority to block or force divestiture of mergers and acquisitions that the Monopolies and Mergers Commission investigated and found to be against the public interest. A Department of Trade and Industry official said that acquisitions can be blocked for national interest reasons. The Secretary has 6 months after a merger to request that the Monopolies and Mergers Commission investigate the merger. The commission has up to 6 months to investigate the merger, but the Secretary may authorize an additional 3 months. Companies can appeal the Secretary’s decision to the judicial system.

The Fair Trading Act broadly defines the term “against the public interest.” The law requires that the commission consider such factors as (1) effect on competition in the United Kingdom, (2) consumer interests, (3) development of new products, (4) cost reduction, (5) balancing the distribution of industry and employment, and (6) promotion of competitive activities of U.K. companies abroad. However, the commission is not limited to consideration of these factors.

The Ministry of Defense provides input to the commission when mergers of defense companies are under investigation, regardless of whether the companies are national or foreign-owned, according to a Defense Ministry

¹This act sets a threshold for acquisitions of both publicly held and privately owned companies as follows: (1) the gross value of the U.K. company being acquired exceeds 30 million pounds or (2) the transaction would result in 25 percent or more of goods and services of the same description being supplied by one enterprise.

procurement policy official. The Ministry of Defense's objective is to ensure that the investigation's results do not adversely affect its ability to obtain value for money on procurement or inhibit competition for defense procurement.

Other Limitations on Foreign Investment

The United Kingdom maintains restrictions on foreign investment activity in certain sectors of the economy. Under the OECD Code of Liberalization of Capital Movements, the United Kingdom reserves the right to restrict foreign investment in air transport, broadcasting, and maritime transport. In addition, the United Kingdom reports limitations to the OECD National Treatment Instrument based on public order and essential security considerations in the following areas: investment in aerospace and maritime transport and obtaining government defense procurement contracts. The National Treatment Instrument also lists further measures taken by the United Kingdom affecting corporate structure in certain defense firms.

Government Involvement May Inhibit Foreign Direct Investment in Some U.K. Companies

Company officials we interviewed stated that the legal and regulatory framework in the United Kingdom is not a barrier or disincentive to foreign investment. However, one U.S. company official stated that the involvement of the U.K. government in some U.K. defense companies could inhibit foreign investment. After it privatized three major defense companies, the U.K. government maintained limits on foreign ownership for public order and essential security reasons. This government control and authority is not rooted specifically in law. Instead, this involvement arises from government ownership of a "golden share" established in the articles of incorporation of these companies. This share does not give the U.K. government control over the companies' routine business activities, investment decisions, or appointments. In each case, the articles provide British citizenship requirements for the companies' board of directors. Other limitations are the following:

- The articles of incorporation for British Aerospace PLC limits foreign ownership of voting stocks to 29.5 percent.
- The articles of incorporation of Rolls Royce PLC also limits foreign ownership of voting stocks to 29.5 percent. Furthermore, the U.K. government has the power to veto major disposal of assets.
- The articles of incorporation of VSEL restrict the size of any shareholding interest (domestic or foreign) but also provide the government a veto on major asset disposal decisions. The recent acquisition of VSEL by GEC

was accompanied by an amendment to the articles of incorporation of VSEL to allow GEC alone to exceed the 15-percent limitation on individual shareholdings. The U.K. government does not hold a golden share in GEC, but it will continue to hold the VSEL golden share.

United Kingdom Offers Investment Incentives

The national and local governments offer incentives to both foreign and domestic companies to invest in designated areas in the United Kingdom to promote economic development. For example, incentives to invest in Northern Ireland include grants of up to 50 percent of project cost and corporate tax relief. In one nationwide program, companies making investments related to technology innovation or introduction into the United Kingdom are eligible for government grants. General economic factors also serve as incentives and include labor costs and corporate tax rates that are lower than in many other European countries and no restrictions on sending capital and profits abroad.

U.S. Companies Use Approaches to Defense Procurement Other Than Foreign Direct Investment

U.S. defense company officials generally did not see direct investment as an essential part of their strategy to gain access to the U.K. defense market. Rather, companies pursue access through the common practice of forming project-by-project teaming arrangements with U.K. companies to gain access to defense procurement contracts. For example, McDonnell Douglas teamed with Westland to win a recent competition to supply the British army with attack helicopters. In another case, Lockheed was awarded a contract to deliver 25 C-130J transport planes to the Royal Air Force. In this instance, Lockheed was the prime contractor and was part of a consortium of 36 U.K. companies that was formed to successfully compete for this procurement.

One U.S. defense company, however, became a U.K. company by incorporating in the United Kingdom. Company representatives indicated that, for business reasons, it was important to adopt a British identity. However, the U.S. company is not investing in a manufacturing facility in the United Kingdom. Furthermore, the U.S. company teams with other U.K. firms to compete for contracts. For example, in one case the U.S. company acted as prime contractor, but in another case, a U.K. company acted as prime contractor.

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