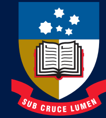

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Monitoring the impact of the EU's new foreign investment screening mechanism

Institute for International Trade

Executive Summary

The policy challenge: Since 2020, the European Union (EU) has maintained a framework for foreign investment screening. It sets the parameters for Member State mechanisms to review foreign direct investment (FDI) on national security grounds and gives the European Commission a coordinating role. The adoption of the EU screening framework is part of Europe's response to the rise of geoeconomic competition for critical resources and strategic assets.

> The EU has realised that to be able to pursue autonomous policy goals, it needs tools to manage the risk of undue foreign state influence and coercion that may result from FDI.

No later than the 12 October 2023, the European Commission must present to the European Parliament and the Council a report evaluating the functioning and effectiveness of the EU investment screening framework and, if appropriate, a legislative amendment proposal. Less than a year before that deadline is set to expire, the Commission is faced with a pressing problem: how to conduct an appropriate ex-post impact assessment of the EU investment screening framework without comprehensive Member State reporting of relevant data and reliable measures of the impact of the new framework on the volume and composition of FDI. However, since the Regulation does not go into any detail to specify what type of information needs to be reported on FDI, the Member States must decide what items of information to report, resulting in differing levels of reporting across the block.

The policy response: When the investment screening framework was proposed, concerns about protectionism fuelled a debate about whether EU-wide investment screening would increase European businesses' funding costs and perhaps would result in negative repercussions for European investors abroad, notably in China. Such concerns strengthened the hand of those who advocated for a cautious approach to a field traditionally reserved for the Member States. A compromise was found that included a requirement for Member States to report unspecified annual aggregate statistics on their activities to the Commission and tasking the Commission with evaluating and proposing further legislation within three years.

As the deadline approaches, it has become clear that the Commission's monitoring tools are insufficient. It is reliant on Member States being forthcoming with statistics that could support the case for a legislative expansion of the Commission's competences. The Commission's first annual report on the implementation of the framework was striking in its absence of key metrics that would allow an ex-post assessment of the framework's impact on investment flows. Notably, it included no

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information on the breakdown of screened investments and screening decisions by countries of origin of inbound FDI. It presented aggregate data on the number of screening cases but not on the value of investments screened, which would allow for pricing of the security externalities identified in the screening process.

This policy brief outlines the Commission's monitoring mandate over investment screening activity. It then proposes a set of parameters for measuring the impact of screening on investment flows, investment destinations, and funding cost, and for mapping the potential transformative effect of the EU investment screening framework on the European investment landscape.

Introduction: Europe's half-way house

The Geoeconomic shift

The European Parliament and the Council of the European Union adopted the FDI Screening Regulation in March 2019.[1] This marked a momentous step: for the first time since the Union was established, it stepped back from free market liberalisation. For the last thirty years, ever since the Maastricht Treaty of 1992, the European Union has extended a guarantee of free movement of capital to and from countries outside the Union.[2] This unique constitutional feature attests to Europe's commitment to economic openness towards the rest of the world adopted during the second half of its more than 60-year existence.

However, by the second decade of the present century, it had become politically undeniable that the juggernaut of global economic liberalization had come to a pause. The economic stagnation following the global financial crisis of 2008, coupled with the continued rise of China at the expense of the incumbent leadership of the United States, has given rise to a more contested and volatile global order. Global economic interdependence, once hailed by liberal internationalists as the driver of global peace and prosperity, has increasingly been viewed as a risk. The shift towards geoeconomics recognizes that interdependence also leads, not only to global economic contagion effects but also to security externalities that make countries more vulnerable to potentially hostile or otherwise harmful behaviour of other countries.[3] Considering the emergence of China as an economic and political power, governments increasingly use economic policy to defend their national security and other non-economic interests at the expense of multilateralism.[4]

One key policy response to this more contested 'geoeconomic' global environment has been broader and more rigorous screening of FDI.[5] Increasingly, technology infrastructure, energy and climate resilience, industrial innovation, data, and media have become 'weaponized' and viewed as instrumental to national security in the new geoeconomic competition between states. Not only the United States but also individual EU Member States had been expanding and elaborating their legislation for reviewing and potentially blocking FDI on national security grounds.

In response, the EU and its policymakers have been emphasizing the need for Europe to become strategically autonomous and capable of projecting geoeconomic power to compete and survive. Nevertheless, the logic and assumptions underpinning geoeconomics remain fundamentally alien to the EU's core principles and its hitherto diehard adherence to the precepts of global economic liberalisation.

Sceptics continue to fear that investment screening will open the door to protectionism. They fear that the nebulous concepts of "security" and "public order" can be invoked on a whim to protect moribund domestic industries. Moreover, there continues to be a concern that screening will scare away investors and make it more expensive to raise much-needed investment capital. Finally, many politicians fear retaliation from China in the event that Chinese strategic investments are blocked.

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The EU FDI screening regulation: Work in progress

In light of the circumstances prevailing at the time of adoption, it is not surprising that the FDI Screening Regulation appears by some measures a half-measure. FDI screening in the EU remains the task of the Member States. The Regulation does not require Member States to adopt screening mechanisms. In fact, as of writing, 18 of the 27 Member States have screening mechanisms and seven Member States are in considering, planning, or in the process of adopting one.[6] Nor does the Regulation equip any EU institution with a legal competency to apply a screening mechanism to any inbound FDI to a member state economy, let alone replace the Member States' mechanisms. The role of the European Commission is to issue opinions to Member States with respect to FDI planned, completed, or undergoing screening in a Member State.[7] It is then left to the Member States to consider the Commission's opinions before taking what the Member views as appropriate action.[8]

The weak thrust of the FDI Screening Regulation was recently confirmed by a survey conducted by the OECD.[9] However, it was already well noted during its adoption process, reflecting a compromise between those Member States who pushed for EU regulation in this field and the European Commission who favoured a more cautionary approach.[10] Instead of proposing an EU-level screening authority, the Commission proposed a framework for coordinating Member State national screening mechanisms, leaving it up to Member States to decide whether they wanted to maintain such mechanisms.

According to the compromise reached, the European Commission will evaluate the functioning and effectiveness of the Regulation and present a report to the European Parliament and the Council no later than 12 October 2023.[11] The report shall be accompanied by proposed legislative text for any amendment recommended in the report. It will then be up to the EU legislator to decide whether and how the EU FDI screening framework should be reformed and possibly reinforced by new and more powerful tools.

Policy response

The Member States' information advantage

As the October 2023 deadline is approaching, the European Commission is making every effort to conduct a comprehensive impact assessment of the first two full years of application of the FDI screening framework. In this task, the Commission relies on the monitoring provisions of the Regulation.

The Regulation requires all Member States, whether or not they have a screening mechanism, to annually report available aggregate information on FDI in their territories and on cooperation requests from other Member States.[12] In addition, each Member State that has a screening mechanism is required to annually report aggregate information on the application of that mechanism.[13]

The problem is that it is – in a strict legal sense – entirely up to the Member States to decide what items of information to report. The Regulation does not contain legally binding provisions that go into any detail to specify what type of information needs to be reported on FDI or on the application of a screening mechanism. To somewhat remedy this obvious *lacuna*, the Commission added a statement published together with the Regulation, in which the Commission undertook to prepare standardized forms to facilitate the Member States' compliance with their reporting obligations.[14] However, that statement is of dubious legal value. The Member States did not agree legally to be bound by the forms, nor were the forms adopted as a legally binding act. Moreover, the forms in question relate to transaction-specific information sharing, not to the type of information on aggregate FDI-related statistics that would go into the annual reports pursuant to Article 5 of the FDI Screening Regulation.[15] Thus, the forms do not help in any significant respect to gather empirical data and detailed descriptive statistics on the economic impact of the FDI Screening Regulation.

At the very moment the Commission is seeking to marshal comprehensive Member State data and devise reliable measures of the impact of the new framework on the volume and composition of FDI, all it can do is to ask the Member States nicely and hope that they will play along.

Europe's strategic data deficit

One of the most important messages the Commission should send its 2023 evaluation report is that its own monitoring tools are insufficient and need to be expanded. That the Commission is dependent on Member States' good will in supplying critical statistics is not sustainable. Rather, it risks being exploited by divergent interests among the Member States, as well as between Member States and the Commission, regarding the screening regulation's application.

Just how difficult it has been for the Commission thus far to obtain relevant data is obvious from its first annual report published in 2021.[16] The report did not present key metrics on the impact of the

screening framework on investment flows. The aggregate data presented listed the number of screening cases but no measure of their significance, such as transaction value. It did not include information that would enable an assessment of the home countries inbound FDI subjected to screening. The data that were presented could not be used for any attempt to measure the cost to society of addressing security externalities (i.e., what society is willing to pay to ensure national security) and what screening may cost businesses in terms of higher marginal funding costs.

Although the Commission's second annual report displays a marked improvement in the scope and depth of presented statistics, it is nevertheless apparent that most FDI data have largely been sourced from the OECD, UNCTAD, and commercial data providers.[17] Data sourced from the Member States are incomplete and difficult to compare.[18]

Did the Commission have access to more relevant data but decided not to publish it? That seems unlikely, in part because that would contravene the Commission's reporting obligation, and, in part, because of the innocent character of the unreported data, e.g., aggregate value and origins of FDI, compared to the data that it did publish.

This begs the question of what information the Commission should be obliged to collect and report. Similarly, what information should the Member States be obliged to divulge to the Commission? A good starting point would be to look at reporting by the U.S. screening authority, the Committee on Foreign Investment in the United States (CFIUS). In its 2021 annual report, it presented detailed data on notified transactions, including by number, business sectors of both the investor and the target, the investor's home country, as well as CFIUS review processing time, among other things. It also included specific, cumulative, and trend data for FDI transactions and investigations, and detailed information about transaction values, both cumulative and broken down by the home country of the investor and by industry represented.[19]

More importantly, it is worth reflecting on the purposes of the data collection and reporting. One such purpose should be to allow an assessment of the potential transformative effect of the EU investment screening framework on the European investment landscape. From a political perspective, it is important to understand whether any additional supporting measures are needed to counter any negative effect of the screening framework while safeguarding the security and resilience of EU capital markets, such as by strengthening the intra-EU investment protection regime to make Europe more attractive to FDI. For that purpose, it is appropriate to agree on a set of parameters for measuring the impact of screening on investment flows, investment destinations, and funding cost. Ultimately it will be important to know what costs Europeans are paying to maintain the Union's economic security.

Another important purpose is to evaluate the overall effectiveness and efficiency of the EU screening framework and the individual Member State screening mechanisms. Can the EU's decentralized screening regime be improved so that it can deliver the desired level of economic security on the best possible terms? Does the regime need to be amended for that purpose and if so how?

The answer to these questions is undoubtedly yes. As the Commission prepares its 2023 evaluation report and possible legislative proposal, it needs to emphasize the need for robust internal transparency as an essential precondition to operate an EU wide investment screening framework. Without reliable means of monitoring the impact of such a framework, it will not be possible to apply it effectively and efficiently in accordance with its purpose.

About the author

Jens Hillebrand Pohl is a Research Scientist in the Faculty of Management and Business at Tampere University, Finland.

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Further enquiries

The University of Adelaide SA 5005 Australia
enquiries iit01@adelaide.edu.au
phone +61 8 8313 6900
web iit.adelaide.edu.au