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Assessing the European Commission's proposal to address distortions caused by foreign subsidies[1]

Executive summary

The main objective of the European Commission "Proposal" for regulation of foreign subsidies is to level the playing field on which firms compete within the EU Single Market. Tackling state-backed subsidisation of foreign companies has the potential merit of allowing EU and non-EU companies to compete on a more even footing. However, as this research paper explains, the European Commission has not adequately considered some of the important negative consequences of its Proposal for foreign direct investment ("FDI") and, therefore, for European consumers.

It is striking that China, which appears to be the main reason for this proposal, as it accounts for a very substantial proportion of the subsidies reported to the WTO by the EU's top 5 trading partners, is the source for a very small fraction of FDI into the EU. Hence, this wide-ranging Proposal risks imposing a burden on firms engaged in such FDI that bears little relationship with the risk of distortive subsidy.

The Proposal introduces three separate investigative tools: two ex-ante notification processes – one for larger concentrations and another for larger public procurement procedures – and a 'catch-all' ex-officio tool which encompasses all other situations. It gives the European Commission the power to impose strong redressive measures where it identifies distortive foreign subsidies, including divestments, publication of research and development results, and licensing on FRAND terms.

The measures proposed can be expected to **affect foreign investors' willingness to pursue business ventures in the EU Single Market**. They **create significant new risks that will affect all firms that might be suspected of benefiting from foreign subsidies**. As the Proposal sets out a very broad definition of foreign subsidies, there is a risk this will be the case whenever firms, including EU firms, have entered into commercial relationships with third country governments, for example. (And whereas EU State aid is evaluated on an ex ante basis, decisions on foreign subsidies will only be made following notifications in relation to relevant concentrations or public procurement procedures, or ex officio investigations by the European Commission.) The lack of precision as to what will be regarded as a distortive foreign subsidy, combined with the threat of strong and far-reaching redressive measures where the European Commission decides this to be the case, exacerbates the uncertainty and risk that firms will face. Indeed, investors might reasonably fear investigation and the burden this will impose, even if they would, ultimately, be exonerated.

A foreign subsidy does not necessarily distort competition. And even if a distortion arises, any negative effects may be offset by economic benefits. As the Proposal **offers no guidance or commitment as to when the positive effects of foreign subsidies will be deemed to outweigh negative effects**, it heightens uncertainty and is liable to deter some investors from engaging in the Single Market.

The Proposal **poses a risk to competition in the EU Single Market**. The broad and vague scope of the Proposal as currently drafted, together with the extent of potential redressive measures, can be expected to inhibit flows of foreign direct investment into the Single Market, irrespective of their origins or whether they involve distortive subsidies. Yet, such investment can provide an important stimulus to competition, notably when it results in new market entry. In turn, increased competition typically results in lower prices and/or higher quality products, benefiting European consumers. The negative consequences for competition of reduced inflows of foreign direct investment add to the costs of the Proposal. They cannot be ignored when evaluating the impact of the proposed intervention.

1 The preparation of this paper has been supported by the Computer & Communications Industry Association. The opinions expressed are those of RBB Economics and do not necessarily represent the views of CCIA or of its members.

Public procurement, for example, is a particular focus for the proposed intervention. However, with spending of around €2 trillion (or 14% of GDP) involved every year in the EU, any reduction in competition for tenders induced by the Proposal will have material consequences for European consumers.

Additionally, the Proposal **poses a broader, direct risk to the European economy**. Foreign direct investment is an important contributor to innovation, and it has a positive impact on employment and wages. Inflows of foreign direct investment also contribute more generally to economic growth in the EU Single Market. This is particularly worrying given the effects of the COVID-19 pandemic on the European economy.

Finally, **the Proposal risks a reduction in outward foreign direct investment by European companies, to the detriment of the European economy and European consumers**. European firms may be deterred from undertaking such foreign direct investment where it involves financial contributions by third countries and, thus, exposure to the proposed Regulation. As noted, such contributions can arise in a variety of situations. Moreover, third countries, notably **the EU's major investment partners (such as the US and the UK), may respond to the Proposal by instituting retaliatory restrictions on investment by EU firms in their economies**.[2] This will reduce the ability of European firms, including SMEs, to expand and enter new markets, as well as potentially limit their access to resources that are not available within the Single Market.

Introduction

The stated objective of the European Commission ("Commission") Proposal for a regulation on foreign subsidies distorting the internal market is "*to effectively tackle foreign subsidies that cause distortions and harm the level playing field in the* [European] *Single Market*".[3] This Commission initiative responds to claims that European companies, which are subject to EU State aid rules, compete on an unequal footing with recipients of foreign subsidies. Commissioner Vestager (speaking at The Wall Street Journal's CEO Council Summit) has observed, for instance, that "[w]*e have seen examples of acquisitions [and have] strong suspicions in giant tendering procedures, where businesses that have to stand on their own feet and make the business case … are undercut by businesses that get subsidies from foreign governments*".[4]

The Proposal introduces three separate investigative tools aimed at enabling the Commission to identify and address foreign subsidies that distort competition in the internal market. For these purposes, a foreign subsidy is defined very broadly, as "*a financial contribution which confers a benefit to an undertaking engaging in an economic activity in the internal market*", creating extensive scope for intervention.[5]

The new tools comprise:

- two ex-ante notification processes: one for larger concentrations (involving turnover of at least €500 million[6]) and another for larger public procurement procedures (with a value of at least €250 million[7]), and
- a 'catch-all' ex-officio tool which encompasses all other situations, including smaller concentrations and public procurement procedures.[8,9]

The Proposal gives the Commission the power to impose an extensive suite of redressive measures on firms in receipt of distortive foreign subsidies, including divestment of assets, access requirements, and reductions in market presence.[10] It also empowers the Commission to prohibit affected concentrations and the award of procurement contracts.

With this Proposal, the Commission is sending a signal to foreign governments that it intends to crack down on the subsidised activities of foreign companies in Europe.[11] Chinese state subsidies may provide the principal motivation and target for the Proposal. (According to figures reported at page 51 of the Proposal document, China accounted for over 95% of the subsidy amounts reported to the WTO by the EU's top 5 trading partners, i.e., China, the US, Russia, the UK, and Switzerland, in 2018.) However, the Proposal applies equally to all businesses operating in all industries in the EU Single Market that are suspected of benefiting from state subsidies from any third (i.e., non-EU) country. As explained further in this paper, the Proposal could thus have a wide-ranging impact on inflows of foreign direct investment ("FDI") to the EU.

2 A barrier to FDI inflows into Europe may generate retaliation in various areas where there has been cooperation with other countries. For example, *"the US has been the biggest third country participant in EU research and innovation programmes for many years"*. Source: https://ec.europa.eu/info/research-and-innovation/strategy/strategy-2020-2024/europe-world/international-cooperation/united-states_en (accessed on 23 August 2021).

3 European Commission Press Release, 5 May 2021. ('Commission proposes new Regulation to address distortions caused by foreign subsidies in the Single Market'.)

4 See https://www.wsj.com/articles/eu-to-crack-down-on-chinese-state-subsidizedcompanies-11620199976 (accessed on 23 August 2021).

5 See Article 2(1) of the proposed Regulation.

6 The acquired undertaking or at least one of the merging undertakings generates an aggregate turnover in the European Union of at least €500 million.

7 The estimated value of that public procurement is equal or greater than €250 million.

8 See page 10 of the Proposal at https://ec.europa.eu/competition/international/overview/proposal_for_regulation.pdf (accessed on 23 August 2021).

9 The Proposal notes that a distortion of competition is unlikely to arise where foreign subsidies have totalled less than €5 million over a three-year period.

10 See Article 6(3) of the proposed Regulation.

11 Since 2017, the EU alongside the US and Japan have expressed concerns regarding the Chinese FDI subsidies, calling for tougher World Trade Organization restrictions on government subsidies. See, for example: i) "US, Japan and EU target China with WTO rule change proposal" in Financial Times, 14 January 2020, available at https://www.ft.com/content/8271be9a-36d6-11ea-a6d3-9a26f8c3cba4 (accessed on 23 August 2021); ii) "How the U.S., the EU, and Japan Are Trying to Rein in China's State Capitalism" in *Harvard Business Review*, 9 November 2018, available at https://hbr.org/2018/11/how-the-u-s-the-eu-and-japan-are-trying-to-rein-in-chinas-state-capitalism (accessed on 23 August 2021); and iii) the Proposal, page 2.

It is striking in this regard that investment originating from China represents only a tiny portion of overall FDI into the EU. In 2017, China held less than 1% of the stock of FDI in the EU.[12] Its share of FDI inflows into the Single Market is also very small (less than 3% in 2019) and has declined.[13] That share is even smaller for Chinese state-controlled companies.[14] However, the Proposal will also apply to – and affect – investments from the US, and the UK, which account for a large proportion of the total FDI inflows into the EU.[15]

Given the extreme contrast in the geographic origins of subsidies and of FDI into the EU, the broad remit of the Proposal risks imposing a burden on firms engaged in such FDI that bears little relationship with the risk of distortive subsidy.

The rest of this paper is organised as follows:

- Section 2 explains how the Proposal could reduce FDI inflows to, and outflows from, the EU Single Market;
- Section 3 discusses how the Proposal could limit competition; and
- Section 4 highlights the general risks to the broader European economy that the Proposal would likely raise.

The Proposal risks reduced FDI inflows to and outflows from the EU Single Market

The Proposal risks reduced FDI inflows

The new investigative powers established by the Proposal will create novel risks for firms competing in the EU Single Market. The new powers will affect both foreign firms and EU companies that are suspected of benefiting from foreign subsidies, which can be the case for example when firms have entered into commercial relationships with third country governments. The risks are exacerbated by the vagueness of the Proposal as to what will constitute a distortive foreign subsidy,[16] combined with the threat of strong and far-reaching redressive measures where the Commission decides this to be the case.[17] Unlike State aid, the Commission will not make up-front decisions on whether foreign financial contributions constitute (distortive) foreign subsidies.

A careful balancing assessment is warranted before action is taken against subsidised investments. Even where the Commission finds that a foreign subsidy would "*distort the internal market*", this may nevertheless bring about increased inflows of FDI into the EU and an intensification of competition. European consumers would benefit as a result. Policy in this regard should be shaped by the welfare of those consumers and not the interests of particular European firms.

Importantly, not all foreign subsidies distort competition, as the Commission acknowledges.[18] However, it is unclear exactly when a foreign financial contribution will be deemed to be a distortive subsidy.[19] This creates significant legal uncertainty for firms that have benefited from financial contributions from third countries. These firms may reasonably fear that such contributions could be deemed to be subsidies that distort competition, even when they do not. The firms in question would then risk all the consequences of a negative finding were they to proceed with investment within the EU Single Market, including exposure to a range of redressive measures and the prospect of fines of up to 10% of annual turnover for non-compliance with Commission decisions.[20]

The Commission recognises, in principle, that even a distortive subsidy may have a net positive effect on economic activity, and that a balancing exercise may be warranted in deciding on appropriate redressive measures.[21] However, the Proposal offers no guidance or commitment as to when the positive effects of foreign subsidies will be deemed to outweigh negative effects.

12 See https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Foreign_direct_investment_-_stocks#EU-28.E2.80.99s_inward_and_outward_investment (accessed on 23 August 2021).

13 Chinese FDI inflow to the EU dropped by almost 70% from €37.3 billion in 2016 to €11.7 billion in 2019, representing less than 3% of the inflow of FDI that year. See page 9, Figure 2, in the report at https://merics.org/sites/default/files/2020-05/MERICS-Rhodium%20Group_COFDI-Update-2020%20%282%29.pdf (accessed on 23 August 2021). The total FDI inflow into the EU-28 in 2019 was c. €400 billion (~$447 billion). See Annex table 1, page 238 at https://unctad.org/system/files/official-document/wir2020_en.pdf, accessed on 23 August 2021).

14 China's state-owned FDI in the EU represented only 11% (€1.2 billion and falling) of total Chinese FDI inflow to the EU in 2019. In 2019: (i) the Chinese FDI outflow going into the EU-28 (€11.7 billion) represented c. 3% of the total FDI inflow in EU-28; and (ii) the Chinese state-owned FDI outflow going into the EU-28 (€1.2 billion) represented c. 0.3% of the total FDI inflow in the EU-28. Source: Figure 5, page 12 in the report at https://merics.org/sites/default/files/2020-05/MERICS-Rhodium%20Group_COFDI-Update-2020%20%282%29.pdf (accessed on 23 August 2021).

15 At the end of 2019, the US held 28.1% and the UK 17.9% of the FDI stock in the EU-27 (excluding the UK). See https://ec.europa.eu/eurostat/web/products-eurostat-news/-/ddn-20210219-2 (accessed on 23 August 2021).

16 See Articles 2 and 3 of the proposed Regulation.

17 See Article 6 of the proposed Regulation.

18 See, for example, Article 3 (2). "*A foreign subsidy is unlikely to distort the internal market if its total amount is below EUR 5 million over any consecutive period of three fiscal years.*"

19 See Articles 2 to 4 of the proposed Regulation.

20 See Articles 15(5)(a) and 25(3) of the proposed Regulation.

21 See Article 5 of the proposed Regulation.

The Proposal is thus likely to discourage investments in the EU that are supported by foreign financial contributions, even if those contributions are not actually subsidies that have a distortive effect, or where the negative effects of any distortion – if one arises – are offset by benefits. In this context, investment may be delayed at least, until there is greater legal certainty surrounding the application of the Commission's measures. However, firms that have received foreign support might also choose not to undertake investment in the EU at all, preferring instead either to invest elsewhere or simply not to invest. In that case, inflows of FDI to the EU will be reduced. The Commission has itself conceded that this may happen in the short-run.[22] The literature shows that the adverse effect may persist in the long-run too.[23]

The vagueness of the Proposal means that FDI is liable to be discouraged even where no relevant foreign subsidy is received. Specifically, the breadth of and lack of clarity surrounding the definitions of what constitutes a "*foreign subsidy*" and a "*distortion*" create a substantial risk that a distortive subsidy may be suspected, and even identified, by the Commission even where there is not one.[24] For instance, under the Proposal, the Commission may treat financial contributions received for goods or services supplied to foreign public entities as involving potential subsidisation. Foreign investors may, therefore, face the prospect of investigation, and the risk that such investigations will result in substantial redressive measures.[25,26] Examples of such redressive measures include reductions in capacity, divestment of assets, a requirement to dissolve a concentration, and repayment of a foreign subsidy with interest.[27]

Even if firms could be confident that the Commission would ultimately conclude that there was no distortive foreign subsidy involved, adverse effects on FDI may arise. Would-be investors may still be investigated, bearing the burden of such an investigation (e.g., responding to potentially onerous information requests[28]), even if they would eventually be exonerated. Indeed, the fear of investigation and the burdens this would impose may already give rise to adverse effects. Even unsubsidised firms will bear the responsibility for notifying the foreign financial contributions of their main subcontractors and main suppliers when participating in public procurement processes, for example.

Moreover, since the proposed regulation "*shall apply to foreign subsidies granted in the ten years prior to the date of application*" of the regulation (where these are found to distort the internal market after the coming into effect of the proposed Regulation), some companies may not continue to hold the detailed information required to address any concerns effectively.[29] Put simply, the prospect of investigation will raise the cost to foreign investors of doing business in the EU, even before the potential consequences of an adverse finding from such an investigation are taken into account. This cost alone could be sufficient to deter FDI that would otherwise flow into the EU. Once the risk and uncertainty associated with potential adverse findings are also considered, those costs are only increased.[30]

The Proposal is also likely to reduce outward FDI by European companies

For the purposes of the proposed Regulation, a "*foreign subsidy shall be deemed to exist where a third country provides a financial contribution which confers a benefit to an undertaking engaging in an economic activity in the internal market*".[31] Hence, whenever a European company benefits from a financial contribution from a third country (which, as has been noted, is defined broadly in Article 2(2) of the proposed Regulation), it will be in receipt of a relevant foreign subsidy.

22 See page 56 of the Impact Assessment: "*Looking at the value of inward FDI flows into the aforementioned countries, OECD data shows that some decrease in inward FDI could be observed in the year of the introduction of the screening mechanism*".

23 Examples of literature suggesting that FDI restrictions have a negative impact on the inward FDI stocks are the following: i) Ghosh et al (2012), Impact of FDI Restrictions on Inward FDI in OECD Countries, *Global Economy Journal*, Volume 12, Issue 3, Article 1; and ii) Mistura and Roulet (2019), The determinants of Foreign Direct Investment: Do statutory restrictions matter?, *OECD Working Papers on International Investment*, 2019/01.

24 See Article 2 "Existence of a foreign subsidy" of the proposed Regulation.

25 See Article 16 ("Revocation") of the proposed Regulation.

26 Investors in the EU suspected of benefiting from foreign subsidies will be confronted with legal uncertainty whilst this is not the case for firms that received State aid from Member States. This is because State aid must be notified or is subject to block exemptions. Therefore, firms that benefit from State aid can invest without legal uncertainty once the EU State aid is cleared. In sharp contrast, an investor that is suspected of having benefited from a foreign subsidy may have to live with the risk that this subsidy is found distortive when they invest or after they invested.

27 See Article 6 ("Commitments and redressive measures") of the proposed Regulation.

28 Article 11 of the proposed Regulation empowers the Commission "to require an undertaking concerned to provide all necessary information" for its investigations, for example. Article 12 allows extensive powers of inspection.

29 See Article 47 (1) of the proposed Regulation. This data requirement is in sharp contrast with EU State aid regulation, where the burden of maintaining detailed data on the subsidy for 10 years is on the Member States, rather than the companies. See question 46, page 17, in European Commission (2016), General Block Exemption Regulation (GBER) Frequently Asked Questions, available at https://ec.europa.eu/competition/state_aid/legislation/practical_guide_gber_en.pdf (accessed on 23 August 2021).

30 Additionally, for public procurement whose estimated value is equal or greater than €250 million, all bidders "*shall either notify to the contracting authority or the contracting entity all foreign financial contributions received in the three years preceding that notification or confirm in a declaration that they did not receive any foreign financial contributions in the last three years.*" See Article 27(2) and 28(1) of the proposed Regulation.

31 Article 2(1) of the proposed Regulation.

As a result, the firm:

- may be subject to the notification obligations set out in the Proposal;
- risks the burden of an investigation by the Commission (even if the financial contributions at issue relate solely to third country activities of that firm); and
- ultimately risks that the Commission will deem foreign financial contributions to distort competition on the internal market and will impose costly redressive measures.

The Proposal, therefore, risks discouraging outward FDI by European companies that requires financial support from a third country, or that simply results in a financial contribution from a third country. There are a wide variety of scenarios in which such contributions may arise. For example, a European company may simply make a commercial sale to (or purchase from) a third country or state-owned enterprise, or engage in a joint venture with such entities, or be in receipt of research funding from a third country. This risk arises even if the financial contributions concerned do not distort competition on the internal market.

In addition, non-EU countries may consider that the Proposal unfairly limits investment opportunities for their firms, constraining their ability to enter or to expand existing operations in the EU Single Market. As a result, this new instrument may trigger retaliatory measures against European investors, as acknowledged in the Commission's Impact Assessment.[32] Such measures could involve additional controls on European investments, notably in respect of acquisitions by European firms, including SMEs, outside the EU Single Market. Importantly, the scope of any retaliatory action may not be limited to measures that mirror those contained in the Proposal.

Retaliation is a common practice in international trade. Typically, countries that impose trade restrictions experience retaliatory measures. The recent trade dispute between the US and the EU is a good example.[33] After the Trump administration imposed special tariffs on steel and aluminium from the EU, the EU retaliated by setting tariffs on US products such as whiskey, jeans and motorcycles.[34] Another example is the Airbus-Boeing WTO dispute, where the "*EU and US (only recently) agreed to end a 17-year dispute over aircraft subsidies, lifting the threat of billions of dollars in punitive tariffs on their economies in a boost to transatlantic relations*".[35]

If the EU's major trading partners, notably the most advanced, liberalised economies, would respond to the measures proposed by adopting restrictions of a similar nature on investment by foreign firms,[36] this could reduce the scope for outward investment from the EU, affecting the expansion of European firms in major markets.[37] This is particularly concerning given that the EU has strongly subsidised some industries. For example, in fisheries, the EU was one of the top five subsidisers in 2018 (alongside China, the US, South Korea and Japan).[38] Moreover, subsidies have been prominent in the EU response to the COVID-19 pandemic.[39]

The available evidence shows that increased restrictions lead to a reduction in FDI

Numerous studies indicate that increases in regulatory risk and uncertainty impact FDI decisions adversely.[40] Hebous et al (2020), for example, highlights the importance of open and predictable regimes:

> ***To enhance investor confidence and reduce regulatory risk, governments need to remain committed to creating open and predictable environments for FDI.***[41]

32 See heading on "Third countries and international relations" at pages 57 and 63 of the Impact Assessment.

33 See "Trade wars: what are the EU's trade defence instruments?" available at https://www.europarl.europa.eu/news/en/headlines/economy/20180308STO99328/trade-wars-what-are-the-eu-s-trade-defence-instruments (accessed on 23 August 2021).

34 See https://negotiation-blog.eu/tit-for-tat-trade-dispute-between-usa-china-eu/ (accessed on 23 August 2021).

35 See "EU and US end Airbus-Boeing trade dispute after 17 years" in Financial Times, 15 June 2021, available at https://www.ft.com/content/985ae1d6-89eb-46d6-b06c-8299ba70c588 (accessed on 23 August 2021).

36 For example, some of the estimated economic costs for the US economy due to the US-China trade war during the Trump administration include: 300,000 job losses, decrease of 0.3% to 0.7% of GDP, and $1.7 trillion loss in the price of stocks of US firms. See https://www.brookings.edu/blog/order-from-chaos/2020/08/07/more-pain-than-gain-how-the-us-china-trade-war-hurt-america/ (accessed on 23 August 2021).

37 For example, since its entry into force in May 2018, the GDPR has had a significant impact on data protection policy and enforcement in non-EU countries. See "The impact of the GDPR outside the EU", 17 September 2019, available at https://www.lexology.com/library/detail.aspx?g=872b3db5-45d3-4ba3-bda4-3166a075d02f (accessed on 23 August 2021).

38 See "Major Countries Continue to Pour in Funds for Global Fisheries Subsidies" (18 October, 2019) available at https://nereusprogram.org/works/major-countries-continue-to-pour-in-funds-for-global-fisheries-subsidies/ (accessed on 23 August 2021).

39 The EU's 27 countries are all in line to get 800 billion euros in grants and loans from a Covid-19 recovery fund financed by debt raised by the Commission on behalf of Member States. In June 2021, the Commission disbursed the first cash from the Covid-19 recovery fund, i.e. €800 million to 16 EU countries, among them France, Germany, Denmark, Estonia and the Czech Republic. Source: https://www.reuters.com/world/europe/eu-hands-out-first-payments-covid-19-war-chest-2021-06-28/ (accessed on 23 August 2021).

40 See "Major Countries Continue to Pour in Funds for Global Fisheries Subsidies" (18 October, 2019) available at https://nereusprogram.org/works/major-countries-continue-to-pour-in-funds-for-global-fisheries-subsidies/ (accessed on 23 August 2021).

41 Hebous et al. (2020), *op. cit.*

Both inward and outward FDI (whether subsidised or not) are likely to be affected negatively by the Proposal and likely retaliations to it.

The Proposal undoubtedly reduces the openness of the European economy to foreign capital inflows in ways that are very likely to increase values of the OECD FDI Restrictiveness Index for EU countries. Several studies based on that index identify a clear, negative correlation between restrictiveness and capital inflows.[42]

Contrary to the available evidence, however, the Commission suggests that the Proposal would not reduce FDI in the medium to long-term. The Impact Assessment draws on the response to the introduction of FDI screening mechanisms in various EU Member States as a relevant indicator of the likely effects of the Proposal.[43] The Commission concedes that the amount of inward FDI was reduced after the introduction of FDI screening. However, it says that it subsequently recovered to a level similar to that observed prior to the introduction of the new mechanisms.

The Commission's assessment is simplistic and is not sufficiently robust to support the Proposal, especially in light of the considerations described above. Notably:

- The national FDI screening rules considered by the Commission in its assessment are very different in terms of objectives and scope to the Proposal.[44] Hence, the effects are simply not comparable.
- The Commission's assessment of the effects of the screening mechanisms is thoroughly inadequate. It fails to consider properly how FDI might have grown absent the screening measures. It also fails to consider (and control for) the impact of other changes in the host countries' economic and political environments that might have been expected to influence FDI levels.[45] For example, the high inflows of FDI to France in 2017 coincided with President Macron's pro-business reforms.[46]

The Proposal may have a detrimental effect on competition

The Commission has not established that the competitive benefits of the Proposal would exceed the costs

The Commission has not provided any compelling evidence that justifies its Proposal. Notably, the Commission's Impact Assessment does not set out any substantive evidence to support the view that the competitive benefits of the Proposal would exceed the costs, in particular when it comes to FDI.[47]

In relation to subsidised acquisitions, for example, the Impact Assessment acknowledges that sellers of companies will benefit financially if the prices paid for those companies are increased.[48] Set against this, the Impact Assessment observes that more efficient acquirers may be outbid ("*crowded out*") as a result. It then simply asserts, without presenting any supporting evidence, that the adverse impact of this crowding out effect is likely to outweigh any seller benefits. Importantly, the theoretical possibility of such an outcome does not establish the case for new intervention instruments, especially where proven tools to address competition issues are already in place and such additional intervention will have potentially wide-ranging adverse effects on FDI.[49,50]

The Impact Assessment also suggests "*that an uneven playing field due to subsidisation may ultimately lead to increasing market concentration*". Again, however, no substantive evidence to support this claim and that justifies the proposed intervention is provided. Subsidised FDI might enable some acquisitions to take place that would otherwise not proceed. However, there appears no basis to suggest that any hypothesised crowding out of alternative purchasers would lead to increased, as opposed to reduced

42 See footnote 22 above.

43 See pages 56-57 of the Impact Assessment available at https://ec.europa.eu/competition/international/overview/impact_assessment_report.pdf (accessed on 23 August 2021).

44 The purpose of the FDI Screening Regulation "*is to determine the likely impact of FDI on security and public order by considering its effects on, among other things, critical infrastructure, technologies and inputs.*" Source: Page 5 of the Proposal.

45 For the main drivers of FDI identified in the literature see ECB Economic Bulletin, Issue 4/2018, Section 3, available at https://www.ecb.europa.eu/pub/economic-bulletin/articles/2018/html/ecb.ebart201804_01.en.html#toc4 (accessed on 23 August 2021). See also Dellis et al (2017), Walsh and Yu (2010), and Blonigen (2005).

46 See FDI Intelligence (31 August 2018), "Foreign investment to France hits record high", available at https://www.fdiintelligence.com/article/72759 (accessed on 23 August 2021).

47 The executive summary of the Impact Assessment can be found at https://ec.europa.eu/competition/international/overview/impact_assessment_executive_summary.pdf (accessed on 23 August 2021).

48 See the Impact Assessment, page 10.

49 It is widely acknowledged that FDI, whether subsidised or not, can generate important positive spillovers.

50 Below-market finance appears to be negatively correlated with productivity with recipients of support being generally less productive (see page 6, and regression analysis in Table A B.3 at page 99, in OECD (2021), "Measuring distortions in international markets - Below-market finance", available at https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC(2020)5/FINAL&docLanguage=En, accessed on 23 August 2021). This suggests that non-subsidized firms can still compete with subsidized ones. Non-subsidized firms are not necessarily crowded out as expected by the Commission in the Impact Assessment.

levels of market concentration. In any event, any merger that could plausibly have an adverse effect on competition within the Single Market, whether it involves foreign subsidies or not, will be subject to relevant scrutiny and control by the relevant competition authorities, and can only proceed where any competition concerns are addressed.[51,52]

The Proposal itself poses a risk to competition in the EU Single Market. Notably, rather than harming competition, flows of foreign direct investment into the Single Market can provide an important stimulus to competition, notably when they result in new market entry.[53] Public procurement, for example, is a particular focus for the Commission's proposed Regulation. It accounts for spending by public authorities in the EU of around €2 trillion every year (or 14% of GDP).[54] Any reduction in competition for tenders caused by the Proposal risks material adverse consequences for European consumers, therefore.

Subsidised FDI may distort competition only in narrow circumstances

The Impact Assessment recognises that a subsidised firm may offer "*cheaper prices for relevant goods or services*", benefiting consumers.[55] However, it suggests that this can "*distort competition and lead to serious market distortions in the long run*". Notably, the Impact Assessment conjectures that, "*having attained a dominant position, subsidised companies can use their financial strength to engage in predatory pricing*".

Such a concern relies on foreign subsidised firms having both the incentive and ability to engage in low pricing that results in the exit of efficient rivals, with the effect that competition is reduced and prices are increased over the longer run. (This supposes that entry/re-entry will not prevent such sustained increases in prices.) However, the Impact Assessment offers no evidence that this is a likely outcome. On the contrary, such concerns will usually be unfounded. Indeed, cases of predatory pricing in the EU have been rare.[56] In most scenarios, efficient rivals will continue to compete vigorously against subsidised firms and, in the meantime, lower prices will benefit European consumers. Critically, existing competition law tools are already able to address any scenarios in which legitimate competition concerns arise, whether in respect of firms that are in receipt of subsidised FDI or not.

The Proposal risks broader harm to the European economy

Aside from the specific competition considerations identified above, the Proposal also risks harming the European economy more broadly. As detailed in this section, FDI is an important contributor to innovation and economic growth, and has a positive impact on employment and wages.

FDI contributes significantly to innovation in the EU

The contribution of inward FDI to R&D investment in the EU is notable. According to the EU Industrial R&D Investment Scoreboard 2020, the foreign-owned companies surveyed invested around €46 billion in R&D in the EU-27 (excluding the UK) in 2019.[57] This represented for around 25% of total R&D investment by surveyed companies in the EU-27 in 2019.[58] Over 50% of this foreign investment was made by US companies, 10% came from Chinese companies, and under 7% originated from Japanese companies.

51 These issues would not arise at all with in respect of greenfield investment.

52 In principle, a merger involving a foreign subsidy could prevent a more efficient tie-up from occurring. However, such inefficient outcomes are also possible for a host of reasons that have nothing to do with subsidies (e.g. bidders facing financial constraints with strong impact on their bid values, or too optimistic/pessimistic expectations from a bidder). That a proposed transaction might not give rise to the most efficient outcome (assuming that this could even be evaluated in practice) is not grounds for prohibiting a merger under European merger control. Moreover, the possibility of future trades mitigates the concern of an inefficient outcome in the short term. In any event, as noted, the Impact Assessment has offered no evidence (or even a framework for assessing) whether the costs of prohibiting transactions involving foreign subsidies would exceed the benefits.

53 More directly, the requirements set out in the Proposal risk undermining competition from firms that are in receipt of third country financial contributions – notably, in the context of procurement procedures and proposed acquisitions.

54 See https://ec.europa.eu/growth/single-market/public-procurement_en.

55 Similarly, subsidised FDI may increase competition for acquisition targets, to the benefit of sellers. An active market for acquisitions may play a significant role in incentivising entrepreneurial efforts to establish and grow innovative start-ups, for instance. These financial contributions can thus benefit the European economy as they contribute to raising the return on investments for risk-taking entrepreneurs.

56 The Commission had not had a predatory pricing case in 16 years until the Qualcomm case in 2019. Source: https://mlexmarketinsight.com/news-hub/editors-picks/area-of-expertise/antitrust/qualcomm-case-sees-eu-antitrust-officials-dust-off-predatory-pricing-tools (accessed on 23 August 2021). If foreign subsidies would have a significant negative impact on market competition, it might have been expected that the Commission would have pursued more predation and other competition cases involving foreign investors over the last few decades.

57 See Figure S8 on page 8 of The 2020 EU Industrial R&D Investment Scoreboard. The Scoreboard monitors R&D investment flows between the EU and other major partners. The 2020 edition of the Scoreboard is based on 2,500 companies that invested the largest sums in R&D worldwide in 2019. Each invested over € 34.7 million and, in total, R&D investment was € 904.2 billion.

58 Table 2.1 on page 40 of The 2020 EU Industrial R&D Investment Scoreboard indicates that were 421 firms based in the EU-27 in the sample. These invested a total of c. €190 bn in R&D in 2019. According to Figure S8 on page 8 of the Scoreboard, those EU-27 based companies accounted for an R&D investment outflow from the EU-27 of c. €40 bn. This implies that the EU-27 based firms in the sample invested c. €150 bn (= €190 bn - €40 bn) in R&D in the EU-27. The total R&D investment in the EU-27 in 2019 thus comprises €150 bn of domestic investment plus €46 bn of foreign investment, i.e., a total of €196 bn.

In addition, according to the OECD's 2021 report on measuring distortions from below-market finance in international markets, below-market equity appears to be more common in R&D-intensive sectors that rely relatively heavily on intangibles.[59,60] This suggests that the Proposal may have particularly negative effects on R&D-intensive sectors in the EU.[61]

FDI has a positive impact on economic growth

Numerous empirical studies have found a positive relationship between FDI and economic growth in so-called developed countries.[62] This is consistent with the OECD's view that FDI promotes economic progress in various ways:

Given the appropriate host-country policies and a basic level of development, a preponderance of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development.[63]

FDI enables technology transfers that benefit firms operating in the EU Single Market.[64] Moreover, this is not limited to proprietary technologies, but also includes know-how and management techniques. The World Bank has also observed that "*policy makers can bolster foreign direct investment and reap its benefits for short-term growth and long-term economic transformation*".[65]

If the Proposal leads, as expected, to a reduction of FDI, this can also be expected to impact negatively on economic growth in the EU.

FDI is also associated with higher wages and job creation

Inward FDI also has a positive impact on the labour market in the host country.[66] Empirical studies indicate that foreign-owned firms tend to have higher labour productivity and to pay higher wages, outperforming domestic firms in the host economies in this regard.[67] Broadly speaking, FDI tends to be associated with the production of more sophisticated goods using more advanced technology, thereby increasing workforce skills. Moreover, foreign-owned firms contribute to increased demand for skilled labour in the host country as a result, impacting positively on wages at local firms too, notably for skilled labour.[68]

Curtailing the EU's FDI outflows also harms EU investors

The legal uncertainty and compliance burden associated with the Proposal may discourage European firms from taking advantage of foreign subsidies offered to support outward FDI. As noted, European firms could also face restrictions on outward investment if third countries retaliate against the Proposal. This may reduce European firms' access to lower cost resources as well as to new technologies, human capital, and production processes that are not available within the EU Single Market. Ultimately, this would lead to a less competitive European economy.

59 See paragraph 185 on page 81 of OECD (2021), "Measuring distortions in international markets - Below-market finance", available at https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC(2020)5/FINAL&docLanguage=En, (accessed on 23 August 2021).

60 Below-market equity happens when governments provide equity finance on terms that are inconsistent with market principles. See page 6 in OECD (2021), "Measuring distortions in international markets - Below-market finance", available at https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC(2020)5/FINAL&docLanguage=En, (accessed on 23 August 2021).

61 According to Figure S3 on page 3 of The 2020 EU Industrial R&D Investment Scoreboard, the leading R&D-intensive sectors were automobile and other transport (accounting for 34.8% of the total R&D investment made by surveyed EU-27 firms), ICT products and services (21.2%), and health industries (19.2%).

62 See: i) De Mello, L. (1999), Foreign direct investment-led growth: evidence from time series and panel data, *Oxford Economic Papers*, 51, 133-151; ii) Moudatsou, A. (2003), Foreign Direct Investment and Economic Growth in the European Union, *Journal of Economic Integration*, 18(4), 689-707; iii) Choe, J. (2003), Do Foreign Direct Investment and Gross Domestic Investment Promote Economic Growth?, *Review of Development Economics*, 7(1), 44-57; iv) Alfaro, L. (2003), Foreign Direct Investment and Growth: Does the Sector Matter?, working paper; and v) Harms, P. and Méon, P-G (2018), Good and useless FDI: The growth effects of greenfield investment and mergers and acquisitions, *Review of International Economics*, 26(1), 37-59.

63 OECD (2002), Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs, p. 5, available at https://www.oecd.org/investment/investmentfordevelopment/1959815.pdf (accessed on 23 August 2021). See also OECD (2007), Economic and Other Impacts of Foreign Corporate Takeovers in OECD Countries (2007), page 68, available at https://www.oecd.org/daf/inv/investment-policy/40476100.pdf (accessed on 23 August 2021).

64 See Almfraji and Almsafir (2013), section 2.3. Relation between FDI and Economic Growth, pages 208-209, available at https://core.ac.uk/download/pdf/82533638.pdf (accessed on 23 August 2021).

65 See The World Bank (2020), Global Investment Competitiveness Report 2019/2020: Rebuilding Investor Confidence in Times of Uncertainty, available at http://documents1.worldbank.org/curated/en/403901590645496246/pdf/Global-Investment-Competitiveness-Report-2019-2020-Rebuilding-Investor-Confidence-in-Times-of-Uncertainty.pdf#page=13 (accessed on 23 August 2021).

66 See Department for international Trade (2018), "Estimating the economic impact of FDI to support the Department for International Trade's promotion strategy: Analytical report" available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/731144/DIT_FDI_analysis_report_v16_accessible.pdf (accessed on 23 August 2021). This study quantified the positive impact of higher FDI stocks on the labour market in Great Britain. The study found that a 10% increase in the FDI stock in a sector was associated with a 0.382% increase in employment in that sector over the following three years. The study also found that the same increase in FDI stock contributed to an average annual increase in wages of 0.290% in the sector for the following two years. Further, this FDI increase also resulted in a 0.307% increase in labour productivity.

67 See, for example, "Empirical studies of foreign takeovers of local companies" (section 4.2) in OECD (2007): Economic and Other Impacts of Foreign Corporate Takeovers in OECD Countries, available at https://www.oecd.org/daf/inv/investment-policy/40476100.pdf (accessed on 23 August 2021).

68 As labour supply tends to be inelastic in the short run, foreign firm expansion increases demand for labour, which raises wages also at local firms. See Hale, Galina, and Mingzhi Xu (2016), "FDI effects on the labor market of host countries", *Working Paper Series*, 2016-25, Federal Reserve Bank of San Francisco.

FDI outflows from the EU amounted to $455 billion in 2019.[69] (Investment in the US accounts for nearly 35% of all FDI by EU firms.[70]) Limitations of outward FDI would therefore restrict EU firms' investment opportunities significantly.

International retaliation may not just impact large European multinationals, but also SMEs.[71] It has been documented that SMEs account for 30% of all FDI projects undertaken by European investors, and that 45% of investment projects undertaken by European SMEs are located outside the EU.[72] Any retaliatory measures imposed by third countries would increase the barriers that these SMEs face to internationalising their businesses. The impact on SMEs may be particularly severe, as these firms are less likely to have the resources to overcome additional hurdles to expanding their operations abroad.

Conclusion

The Commission's Proposal risks reduced FDI both into and out of the EU. Even where FDI is subsidised by foreign countries in ways that afford competitive advantages to certain firms, it may nevertheless deliver substantial benefits to the European economy as well as to European consumers. The Commission's broad approach can also be expected to discourage FDI that involves no subsidy and results in no distortion. When it comes to FDI, the Commission has failed to establish that the benefits of the Proposal would likely outweigh its costs.

69 See EU's FDI (in and out) flows in 2019 in Annex table 1, page 238, in the World Investment Report 2020 available at https://unctad.org/system/files/official-document/wir2020_en.pdf (accessed on 23 August 2021).

70 At the end of 2017, the US had the biggest share (34.2%) of the EU-28's FDI stocks abroad. See Foreign direct investment – stocks, Statistics Explained, available at https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Foreign_direct_investment_-_stocks#FDI_positions_in_the_EU_Member_States (accessed on 23 August 2021). Moreover, according to "The 2020 EU Industrial R&D Investment Scoreboard", 20% of the R&D funded by surveyed EU companies (€40.1 bn) was undertaken abroad in 2019, 60% of this occurred in the US.

71 Some entrants who bring FDI into Europe may rely on local EU SMEs to set up their operations in Europe. Also, European SMEs benefit from European inward FDI via spillovers, which might, as a result, promote the success of European outward FDI by SMEs. See ESPON FDI (2018), The World in Europe, global FDI flows towards Europe: FDI by European SMEs, section 5.5 Inward FDI as a facilitator of outward FDI, pages 26-29.

72 The World in Europe, global FDI flows towards Europe. FDI by European SMEs. ESPON, 2018.