

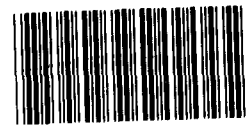
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United States  
General Accounting Office  
Washington, D.C. 20548

General Government Division

B-234511



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July 1, 1992

The Honorable John D. Dingell  
Chairman, Subcommittee on Oversight  
and Investigations  
Committee on Energy and Commerce  
House of Representatives

Dear Mr. Chairman:

As you requested, we have assessed federal agency responses to two of our reports to you: Foreign Investment: Concerns in the U.S. Real Estate Sector During the 1980s (GAO/NSIAD-91-140, June 4, 1991) and Foreign Investment: Analyzing National Security Concerns (GAO/NSIAD-90-94, Mar. 29, 1990). This letter summarizes our assessment.

COMMENTS ON THE REAL ESTATE REPORT

The comments of the Departments of Commerce and Treasury on our report on foreign direct investment in the U.S. real estate sector are discussed below. You also requested that we obtain the viewpoints of the Departments of Agriculture (USDA) and Housing and Urban Development (HUD) on the issues raised in our report.

Commerce Department Comments

The Commerce Department's September 4, 1991, response to our real estate report covered three different items:

1. Cost of capital. In his letter, then-Secretary Robert A. Mosbacher stated that "whether Japanese buyers have a cost-of-capital advantage over U.S. buyers is a complex issue, and cannot be judged solely on the basis of differential interest rate charges on yen and dollar-based loans. Effective tax rates, expected rates of inflation, and differing accounting rules and financial regulations must also be taken into account."

GAO/GGD-92-12R Foreign Direct Investment

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Our report cited two areas of commercial real estate industry concern related to the cost-of-capital issue. The first was concern that Japanese investors had easier access to capital due to close ties to Japanese banks.

The second was concern about the lower cost of capital for Japanese firms; however, the report went on to note that this situation had changed by late 1990.

We agree with Secretary Mosbacher that the cost of capital is a complex issue and that it involves more than review of differential interest rates. However, our objective was to provide information on the concerns that we found in the industry and the interest rate issue was one of the concerns.

In looking at studies that discuss cost-of-capital differences between the United States and Japan, we found that the results depended greatly on the methodology used. However, most studies have found that the cost of capital in Japan was lower than in the United States, although by less than the nominal interest rate differential would indicate. This gap in the relative cost of capital between the United States and Japan was acknowledged in an April 1990 study by the Japan Economic Institute. The institute also noted that the gap was narrowing significantly.

More recently, a February 1992 study by Kenneth Leventhal & Company, 1991 Japanese Investment in United States Real Estate, reflects the rapidly changing developments in the real estate sector since our report was published. The study states that in April 1990, the Japanese Ministry of Finance imposed real estate lending restrictions on Japan's financial institutions that have only recently been eased. The impact of this action and others has changed the cost of capital in Japan. The study also states:

"Japanese investment in the United States peaked in 1988 and is not expected to return to that year's levels in the near future because of an overhaul in Japan's financial system. A restrictive monetary policy, higher bank capital requirements, a declining stock market, the banking industry's low profit margins, and declining land prices have changed the profile of the Japanese financial system.

These changes are restructuring the Japanese financial system into one that focuses more on profits than on growth, places a priority on domestic lending and forces Japan's financial institutions to compete on a more level playing field with the world's banks."

"The surge in Japanese investment worldwide that capped the 1980s was led by the inexpensive cost of capital in Japan and the eagerness of Japanese banks to expand market share. The prevalence of liquidity resulted in higher asset values of Japanese property and financial instruments, which investors borrowed against to acquire vast quantities of real estate (particularly in the United States)...However, the higher interest rates and the resulting crash of the Japanese stock market caused the...shrinking [of] the Japanese banks' capital base. Japan's banks are now being forced to raise capital at higher funding costs at the same time as they are being asked to set aside higher capital reserves in accordance with new international bank standards. The outlook for real estate loans is not favorable since mortgage and construction loans require additional capital reserves."

2. Reciprocal access to foreign real estate markets for U.S. firms. Secretary Mosbacher also raised the issue that foreign real estate and investment firms "may derive some advantages due to the fact that their home markets are in many cases protected from outside investors." This issue was outside the scope of our study. However, a recent review of literature on the institutional investor industry revealed no concerns about the United States being shut out of foreign commercial property markets. A number of articles discussed increasing U.S. investment activities in the European market. An official of the National Association of Realtors told us that although reciprocal access to markets was an important issue in principle, it was not a burning issue for U.S. investors at this time. While restrictions on real estate investments by foreigners did exist in some countries, the degree of restriction varied by country. He noted, for example, that Norway was completely closed to the foreign purchase of real estate and Australia had certain restrictions that limited access to its real estate market. Furthermore, he cited Japan as an example of a country in which commercial real estate was so prohibitively expensive that U.S. investors generally did not even look for investment opportunities there.

3. Impact of foreign direct investment on real estate business cycle. As Secretary Mosbacher noted in his response, Bureau of Economic Analysis (BEA) data that would provide information on this issue is not yet available. Further study will have to await its publication.

#### Treasury Department Comments

The Treasury Department's September 9, 1991, response to our real estate report was very positive, commending its "comprehensive and thorough analysis" and supporting its conclusions.

#### Agriculture Department Comments

We contacted Department of Agriculture officials about USDA oversight of foreign investment in U.S. farmland. We found that the situation had not substantially changed since a review we did on this issue for Senator Quentin Burdick in 1989. In our report, Foreign Investment: Trends in Foreign Ownership of U.S. Farmland and Commercial Real Estate (GAO/NSIAD-89-168FS, July 10, 1989), we found that USDA closely monitored foreign purchases of farmland at the state and county levels and that foreign ownership had accounted for only 1 percent of privately held American farmland in 1988. USDA data for 1990, the most recent available, show that this percentage has held firm. Foreign persons reported that they owned 14.4-million acres, or slightly more than 1 percent of the 1.3-billion acres of privately owned U.S. agricultural land (farm and forest land) as of December 31, 1990. A USDA official told us that USDA has not sponsored a study analyzing the impact of foreign investment on U.S. farmland since 1981 because foreign ownership has so consistently accounted for such a small percentage of American farmland.

#### Housing and Urban Development Department Comments

HUD Secretary Jack Kemp's August 16, 1991, letter to you commented on two issues relating to the U.S. residential property market. The first issue is the inflow of foreign capital into the U.S. property market. Secretary Kemp stated that this inflow has been beneficial in providing American citizens with greater access to capital for investment in real estate, which "means more homes at lower

cost for working Americans and a domestic real estate industry that enjoys greater prosperity and job creation."

The second issue is housing affordability. In this context, Secretary Kemp discussed a set of new initiatives called Homeownership and Opportunity for People Everywhere (HOPE) as part of the National Affordable Housing Act signed into law by the President in November 1990. He also mentioned efforts to reduce regulatory barriers to affordable housing and to maximize access by low- and moderate-income families to residential properties being disposed of by the Resolution Trust Corporation.

COMMENTS ON OUR REPORT ON NATIONAL SECURITY-RELATED FOREIGN INVESTMENTS

The Department of Defense's (DOD) and the Department of the Treasury's comments on our report, Foreign Investment: Analyzing National Security Concerns, are discussed below.

DOD Comments

DOD's October 26, 1990, comments on our report concurred in our finding regarding the types of information-gathering and analysis performed by the administration in reviewing national security-related foreign investments. DOD also indicated four areas in which they only partially concurred.

1. DOD stated that "ownership of U.S. companies by parties from friendly and allied countries (the vast majority of foreign investments) does not inhibit the ability of the U.S. government to gain access to critical items (e.g., under authorities of the Defense Production Act)."

At the time our report was issued, the Defense Production Act (DPA) was still in effect. Under the DPA, the U.S. government could compel any U.S.-based firm to supply defense contractors before other customers. If a foreign-owned, U.S.-based firm were to withhold or delay supplies to defense contractors, the act could be used to compel supply. In one Committee on Foreign Investment in the United States (CFIUS) case we reviewed, in which security of supply to DOD was the principal concern, the DOD Assistant Secretary stated that the DPA was adequate to assure continued supply of an item of national security

interest. DOD's statement regarding the adequacy of the DPA was a key element in CFIUS' decisionmaking in this case. Under the Exon-Florio Amendment, the President must find that provisions of U.S. law, other than the International Economic Emergency Powers Act, are not adequate to protect the national security before he can block a proposed investment. Although the DPA has expired, it is DOD's position that the government continues to have contract priority coextensive with that of the DPA pursuant to other statutes.

Our point, as we noted in our report, is that foreign control of a U.S.-based firm means that decisions affecting research, product choice, and plant modernization can be made abroad. The DPA cannot protect against a decision by a firm, either foreign-owned or domestic, to close down a U.S. plant or change the firm's product line or research direction.

2. With regard to information and analysis available on proposed foreign investments, DOD stated that it is continuing to work on expanding its data base to include lower-tier contractors. DOD agreed with us concerning the difficulty of assessing a foreign owner's intentions regarding technology transfer and the continuation of research programs in the United States. It noted, also, that it is equally difficult to assess the same intentions for domestic owners and legally more difficult, since DOD has no statutory authority to investigate such intentions.

We are aware that DOD is attempting to improve its knowledge of lower-tier contractors, although we have not assessed its recent efforts. We agree with DOD on the difficulty of assessing technology flows; we believe, however, that foreign-owned firms would be more likely than U.S.-owned firms to transfer technology out of the United States.

3. DOD stated that it would be extremely difficult to determine if a start-up, "greenfield" company's efforts are going to affect national security. It noted that the establishment of a business presence by a hostile foreign power in the United States would be of concern, but it noted that the hiring of U.S. expertise by a foreign entity could be accomplished without establishing such a business presence.

Our report noted that because new, start-up investments are not covered under the Exon-Florio Amendment, some investments in national security-related sectors may not be reported to CFIUS. Therefore, foreign-owned start-up companies might hire U.S. firms' most skilled scientists and researchers. We agree with DOD, however, that foreign entities can hire U.S. expertise without actually investing directly in the United States.

4. DOD agreed with our assessment that CFIUS is not presently set up to address larger policy questions. DOD also noted that CFIUS does address, on a case-by-case basis, the importance of a firm's commercial business to the production and development of defense systems.

Our report stated that CFIUS operates on a case-by-case approach and does not perform analyses of foreign investment by specific industry sectors. As we noted in our report, CFIUS cannot be expected to provide answers to the types of questions about preserving commercial competitiveness that need to be addressed at higher policy-making levels.

#### Treasury Comments

The Department of the Treasury responded on August 17, 1990, to questions you raised in connection with the Subcommittee's investigation of foreign direct investment in the United States. Treasury's responses indicated partial disagreement with our report in four respects.

1. With regard to our observation that CFIUS does not perform analyses of foreign investment by industry sector, Treasury stated that CFIUS considers foreign acquisitions in the context of the industry sector and that concentration of foreign ownership and market share information are considered.

Our reviews of CFIUS' processes<sup>1</sup> have indicated that CFIUS considers proposed foreign investments individually, on a

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<sup>1</sup>See also "National Security Review of Two Foreign Acquisitions in the Semiconductor Sector," (GAO/T-NSIAD-90-47, June 13, 1990), and "National Security Reviews of Foreign Investment," (GAO/T-NSIAD-91-08, Feb. 26, 1991).

case-by-case basis. CFIUS focuses on developing information to meet the law's specific requirements regarding (1) the investment's link to national security, (2) the existence of "credible evidence" that the foreign interest might take action threatening to impair U.S. security, and (3) the adequacy of other laws to protect national security. While CFIUS may obtain information on foreign ownership and market share in the sector, it does not prepare sectoral analyses examining, for example, foreign-owned firms' competitive practices and market strategies. Indeed, CFIUS has no criteria in law or regulation for examining unacceptable market concentration or foreign dependence. U.S. antitrust laws administered by the Justice Department and the Federal Trade Commission would be the relevant basis for analyzing possibly excessive market concentration.

2. Treasury's comments on greenfield investments were the same as DOD's comments, discussed previously in point #3.

3. Treasury described ways in which the government is trying to improve the knowledge base regarding foreign investments in the United States. Treasury mentioned DOD's efforts to gain further knowledge of lower-tier subcontractors and the Commerce Department's efforts to link certain types of Census and BEA data to increase the level of detail in existing foreign investment data.

We recently evaluated this data link effort, which was authorized by the Foreign Direct Investment and International Financial Data Improvements Act of 1990 (P.L. 101-533)<sup>2</sup>. It is not yet clear whether this link will solve, as Treasury said it will, the problem of disaggregating foreign investments in the aerospace and semiconductor sectors from their broader data categories.

Due to the need to preserve confidentiality in foreign investment statistics, BEA will be limited in its ability to publish data that might allow the identity of the specific foreign investor to be learned. Since the ability to identify specific investors depends on the number of

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<sup>2</sup>See Foreign Direct Investment: Assessment of Commerce's Annual Report and Data Improvement Efforts, (GAO/NSIAD-92-107, Mar. 18, 1992).



investments in an industry and the amount of the investment, it is possible that data may be suppressed on industries in which a few large investors hold significant control. Once Commerce publishes the results from the data link, expected this summer, it will be possible to see whether aerospace and semiconductor investments can be broken out of their present, much broader data categories.

However, even these data will not be sufficiently current to be of real help to CFIUS. The data to be published this summer will show foreign investments for 1987; foreign investment data for 1988 will be published in 1993.

4. Treasury agreed with us that broader policy questions--such as reserving certain industrial sectors for American ownership, evaluating the importance of firms' commercial strength to defense production, assessing the value of developing high-technology sectors, and judging the problem of industry "hollowing out" because of foreign acquisition of lower-tier suppliers to Defense-- are generally beyond the scope of CFIUS. Treasury noted that CFIUS has the ability to evaluate the importance of a company's commercial strength to its defense role and that CFIUS recognizes the importance of success in civilian markets to U.S. firms' abilities to provide defense-related equipment. However, Treasury also noted that "because defense technologies are largely market-driven, attempting to choose industries would be indistinguishable from industrial policy." Treasury noted the President's strongly held opposition "to any sort of industrial policy, in which the government, not the market, would pick winners and losers."

We note that many defense technologies are not market driven and DOD provides extensive research and development funding for these technologies. Many observers note that while the U.S. government may not enunciate or coherently plan an industrial policy, the many government programs that carry out and provide grants for research and development constitute a de facto industrial policy.

Furthermore, defense-related U.S. firms can face significant obstacles in their efforts to achieve commercial strength by penetrating foreign markets for their commercial products. But these types of impediments

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to trade and investment are not the subject of CFIUS investigations.

I hope that this letter provides the information you need. Please contact me on (202) 275-4812 if you or your staff have any further questions. You may also contact Curtis F. Turnbow, Assistant Director, on (202) 275-5429.

Sincerely yours,

A handwritten signature in cursive script that reads "Allan I. Mendelowitz".

Allan I. Mendelowitz, Director  
International Trade and Finance Issues