Foreign Investment Screening in the EU

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ETSG Conference
University of Surrey
14-16 September 2023

Introduction

European move towards more restrictive FDI regime?

Europe must always defend its strategic interests and that is precisely what this new framework will help us to do. [...] This is what I mean when I say that we are not naïve free traders.

— Jean-Claude Juncker, November 2018
Former President of European Commission

This is not about closing down our markets but about acting responsibly. [...] We are determined to keep our technology sectors and key infrastructure safe.

— Margarete Schramboeck
Former Austrian Minister for Digital and Economic Affairs

What happened?

- Following a *letter of concern* by a few but large EU member states, in 2017, on the *potential risks associated with surging investment flows into* the Union from non-member states, the Commission took action to propose a regulatory framework

- On 19 March 2019: approval of "*Regulation 2019/452 of the European Parliament and of the Council, establishing a framework for the screening of foreign direct investments into the Union*"

- Formal screening mechanisms equip governments with power to screen, prohibit and even unwind acquisitions of domestic firms by foreign (i.e., non-EU) entities

- At that time (and still today), EU has one of the most open FDI regimes worldwide Figure

Motivation and research question

Motivation

Regulatory changes can affect agents' behavior through

- new cost-benefit assessment due to changing transaction costs
- policy uncertainty due to intransparent procedures or discretionary decision making
- evasion or rent-seeking activities

This paper/talk

Empirically evaluate impact of adopting Investment Screening Mechanisms (ISMs) in EU; focus on international mergers and acquisitions (M&As)

Research question: systematically deterring effects as investors seek better options or prefer to wait?

Main findings (so far)

- Significantly fewer M&A deals in Western European countries
  - especially in shorter/more recent sample and when ISM is aligned with regulation
  - no systematic effect on number of postponed or withdrawn deals

- Heterogeneous effects depending on investors' origin
  - greater decline for buyers/GUO from politically distant countries
  - government involvement (i.e. state control/ownership) ambigious

Outline

1. Background on the regulation

2. Data, descriptive stats and empirical approach

3. Results so far, road-map and (preliminary) conclusions

1. Background on the regulation

Regulation (EU) 2019/452, henceforth, *the Regulation*

- guidelines for investment screening in the EU, plus forum of exchange and collaboration
- focus on concerns related to possible effects of foreign investments on national security and public order
- Article 2 defines screening as "procedure allowing to assess, investigate, authorise, condition, prohibit or unwind foreign direct investments"
- investment screening mechanism (ISM) referred to as "an instrument of general application [...] setting out the terms, conditions and procedures" of screening.

1. Background on the regulation (cont'd)

*The Regulation* leaves ultimate decision power to member states, but suggests focus on

- possible impacts on (i) critical infrastructure; (ii) critical technologies and dual use items; (iii) supply of critical inputs; (iv) access to sensitive information; and (v) freedom and pluralism of the media
- investor characteristics, such as ultimate (state) ownership, past investments in critical activities, or risk of illegal and criminal activity

⇒ Overall, significant broadening of regulatory space related to national security and public order

EU countries differ widely in adoption of ISMs and their alignment with *the Regulation* $\Rightarrow$ use this in the analysis

Number of EU Member states with ISM in place
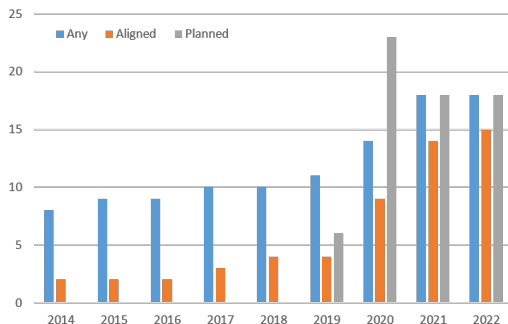
Note: Author's compilation based on information from European Commission (2021, 2022) and UNCTAD Investment Policy Monitor. "Any" counts countries that adopted any law that potentially restricts foreign acquisitions or FDI inflows. "Aligned" counts countries that (partly or fully) aligned their ISM with *the Regulation*. "Planned" counts country in the process of adopting/reforming ISMs in line with *the Regulation*.

2.1. Data

Aim: Analyse how ISM adoption relates to M&As activities of non-EU buyers across EU member states

- Bureau van Dijk's Orbis M&A database
  - Records of deals and rumors across the world, plus info on company characteristics and sector activity
  - Use deal numbers rather than values; good coverage for high-income countries (Erel et al., 2015)

- Sample focuses on Western EU (i.e. 14 countries), EU27 has major data gaps
  - Period covers 2005-2022, but focus on later years when ISM discussion became more relevant
  - Buyer origin identified via country of registration and/or global ultimate owner GUO
  - Baseline: country-pair time variation; no reported transactions assumed to reflect zero deals
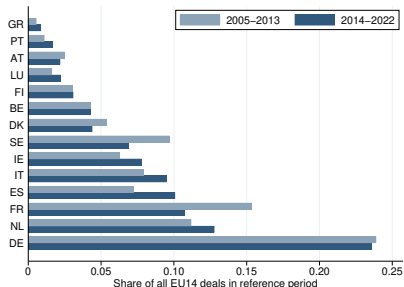
Foreign (non-EU) takeovers in Western Europe, 2005-2022


(a) Evolution over time
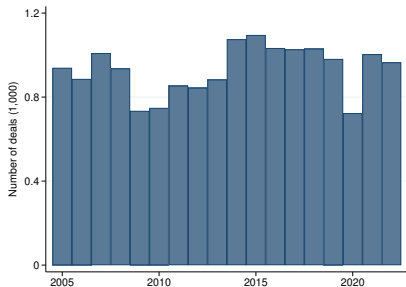
(b) Destinations

Note: Author's calculations based on data from ORBIS M&A. Western Europe refers to 14 EU member states, as displayed in panel (b). M&As count only deals where the target is registered in a Western EU country, while the buyer is registered in a non-EU country.

Identity of non-EU buyer's in Western Europe, 2005-2022

(a) Top 10 buyers

(b) State vs. private GUOs
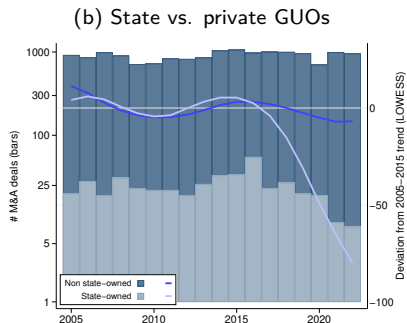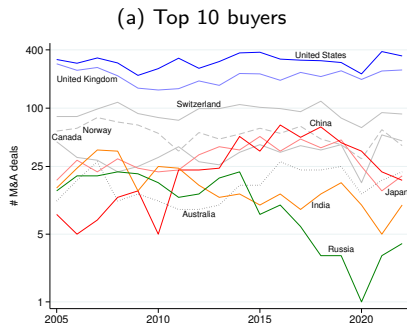
Note: Author's calculations based on data from ORBIS M&A. Buyer country of origin in Panel (a) refers to country where buying firm is registered. State-ownership in Panel (b) refers to identity of global ultimate owner (GUO).

2.3. Empirical approach

Method:

Count data with overdispersion makes PPML estimator preferred choice

Santos Silva & Tenreyro (2006); Santos Silva et al. (2015); Correia et al. (2020)

Baseline model:

- Dependent variable measure number of foreign M&As in EU country i and year t

$$N_{it}^{\mathsf{Deal}} = \exp\{\beta ISM_{i,t-1} + \mathbf{X}_{it} + \mu_i + \mu_t\} \times \varepsilon_{it} \tag{1}$$

- $ISM_{i,t-1} = \{0,1\}$ indicates adoption/planning of investment screening in line with *Regulation*
- Variants of this model distinguish whether ISM is in place or planned
  $\Rightarrow ISM_{i,t-1}^{aligned} = \{0,1\}$ vs. $ISM_{i,t-1}^{planned} = \{0,1\}$

2.3. Empirical approach

BvD M&A data also provides information on buyer/GUO's country of origin/resgistration

- use to inspect heterogeneity in M&A response to investment screening
- focus on political distance/disagreement (Bailey et al. 2017) and/or state-ownership

Augmented model:

- Dependent variable measure number of M&As by firms from j in EU country i and year t

$$N_{ijt}^{\text{Deal}} = \exp\{\beta_1 ISM_{it-1} + \beta_2(ISM_{it-1} \times D_j) + \mathbf{X}_{it} + \mu_{ij} + \mu_{jt}\} \times \varepsilon_{ijt} \quad (2)$$

- Interaction term to detect differential effects of investment screening, depending on buyer characteristic
- $j = \{1, ..., J\}$, $J = 16$: top-10 buyer countries plus 16 world regions list $\Rightarrow$ avoid zero-inflated data

3.1. Baseline results (aggregated sample)

Foreign M&As and ISM adoption in the EU, PPML estimates

Dependent variable: number of deals	(1)	(2)	(3)	(4)
Sample period	2005–22	2014–22	2005–22	2014–22
ISM (planned or aligned)$(t-1)$	-0.045	-0.128**		
	(0.047)	(0.045)		
ISM aligned $(t-1)$			-0.048	-0.135**
			(0.049)	(0.048)
ISM planned $(t-1)$			-0.116	-0.120^{a}
			(0.100)	(0.071)
Observations	208	104	208	104
Control variables included	Yes	Yes	Yes	Yes

Note: Robust standard errors are displayed in parentheses. Statistical significance: ^{a} $p < 0.1$, * $p < 0.05$, ** $p < 0.01$. All specifications include year and country fixed effects. Included control variables are the annual GDP growth rate, measured as the log difference in GDP, the country's debt-to-GDP ratio, as well as a country-specific COVID19 effect, employed as a country-year2000 interactive fixed effect. The estimation sample consists of a balanced panel with country-year observations, where countries represent 14 Western EU member states.

Heterogeneous effects of ISM adoption, buyer characteristics

Dependent variable: number of deals	(1)	(2)	(3)	(4)	(5)	(6)
Buyer characteristics	Political Distance Buyer Residence		Political Distance Buyer GUO		State ownership Buyer GUO	
Sample period	2005-22	2014-22	2005-22	2014-22	2014-22	2014-22
ISM aligned $(t-1)$	-0.083	-0.030	-0.039	0.041	0.017	0.014
	(0.055)	(0.049)	(0.057)	(0.065)	(0.054)	(0.056)
$\times$ Political Distance$_{ij}$	-0.151*	-0.195**	-0.173**	-0.254**	-0.230**	-0.224**
	(0.063)	(0.065)	(0.066)	(0.084)	(0.075)	(0.076)
$\times$ State-owned$_j$					0.045	0.144
					(0.189)	(0.289)
$\times$ Political Distance$_{ij}$ $\times$ State-owned$_j$						-0.234
						(0.575)
ISM planned $(t-1)$	-0.124	-0.077	-0.145	-0.102	-0.362*	-0.365*
	(0.109)	(0.093)	(0.132)	(0.118)	(0.152)	(0.152)
$\times$ Political Distance$_{ij}$	-0.241*	-0.152	-0.218	-0.127	0.426	0.435
	(0.107)	(0.120)	(0.141)	(0.170)	(0.264)	(0.267)
$\times$ State-owned$_j$					-0.944**	-0.554[a]
					(0.225)	(0.304)
$\times$ Political Distance$_{ij}$ $\times$ State-owned$_j$						-0.799
						(0.716)
Observations	4,366	1,961	4,127	1,900	2,691	2,691
Cluster	224	112	224	112	126	126

Note: Results obtained from PPML estimation as in (2). Standard errors in parentheses clustered at destination-year level (it). Statistical significance [a] $p < 0.1$, * $p < 0.05$, ** $p < 0.01$. Sample consists of balanced destination-origin-year panel. Destinations are 14 Western EU countries, origins are top-ten buyer countries, plus sixteen non-EU world regions.

4. Conclusions and next steps

Summary

- Find negative relationship between stricter investment screening and M&A activities at fairly aggregated level
- Results driven partly by adjustments among buyers from politically distant countries
- No clearly differential patterns for state-owned/controlled buyers
- ⇒ Overall, ISM adoption appears to deter non-EU investments

More to be done

- Drill down to sector level ⇒ identify "critical/sensitive" sectors
- Case studies, exploiting detailed information of screening procedures ⇒ explore political economy mechanisms

Thank you!
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OECD FDI Restrictiveness Index 2020
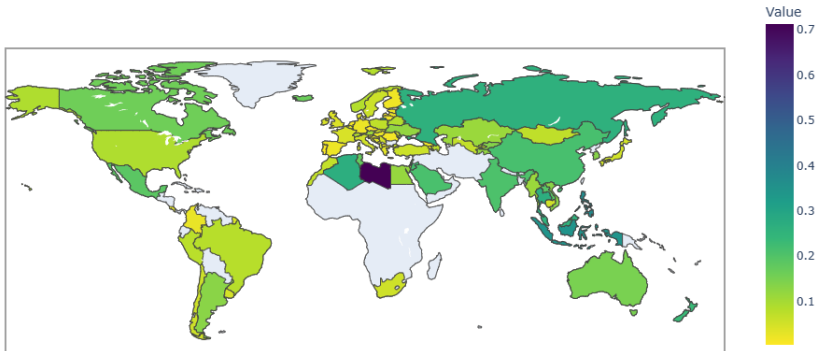
Note: Data uses OECD FDI Restrictiveness Index for 2020 in N = 84 countries. Larger values indicate greater restrictiveness. Index reflects countries' reported total restrictiveness. Map generated in with Jupyter Notebook `OECD_FDIrestrict.ipynb`.

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Backup slides

List of non-EU buyer countries/regions back

Top10 origins	World regions (UN classification)	
Australia	Caribbean	Oceania
Canada	Central & Western Asia	Southern Africa
China	Central America	Southern Asia
India	Eastern Africa	South America
Japan	Eastern Asia	South-Eastern Asia
Norway	East & Southeast Europe	Western Africa
Russia	Middle Africa	
Switzerland	Northern Africa	
United Kingdom	Northern America	
United States	Northern & Western Europe	