Sovereign Wealth Fund Working Group
Transition White Paper

Memorandum
To: President-elect Obama's Transition Team
From: Representatives James P. Moran and Thomas M. Davis, Co-Chairs
Congressional Sovereign Wealth Working Group
Re: Recommendations

The global financial and credit crisis and the tectonic shift in wealth over the last eight years between nations and generations has demonstrated that economic wealth will play a critical role—perhaps more critical than military might—in decades ahead. Today, the United States is no longer capital rich, but rather is a significant international debtor with a sizeable portion of that debt held by central banks in China, Japan, Russia and the Gulf states. This tectonic shift of wealth transfer from the United States to other nations is significant. It appears likely to continue. The current financial credit crisis, moreover, demonstrates that American financial institutions are becoming increasingly dependent on capital from foreign sources, such as central banks and sovereign wealth funds. One of the probable outcomes of the current crisis is the acceleration of the development of alternatives to American financial markets, capital and currency. In a world where Osama bin Laden's 34 percent approval rating in Pakistan is almost double America's (19 percent), it seems clear we must dramatically rethink and change the way we protect and project leadership around the globe. Responding to changing dynamics and wealth shifts will test the new administration as perhaps no challenge in our nation's history. Global leadership will require a much more complex blend of economic, diplomatic, and military roles—or smart power.

By more serious measures of power, the United States is not in decline, not even relative to other powers. Its share of the global economy last year was about 21 percent, compared with about 23 percent in 1990, 22 percent in 1980 and 24 percent in 1960. Indeed, we believe it is remarkable that Sovereign Wealth Funds and central banks have not been dumping the mountains of Treasury bonds and other U.S. assets they hold, much less attacking the dollar systematically, as has happened in past crises.

We attribute part of the reason to the U.S. security blanket that is spread over nations such as Saudi Arabia and Japan or in China's determination not to damage its market access and dollar holdings. However dim U.S. prospects are, most other markets look even riskier. The United States does not weaken alone. A broken America means a broken international system that others will not be strong enough to repair without the U.S. centerpiece.

Moreover, American military power is unmatched.[1] While the Chinese and Russian militaries are both growing, America's is growing, too, and continues to outpace them technologically. Our image is certainly damaged, as measured by global polls. Last spring, majorities in 21 of 23 countries surveyed outside of the U.S. said that what happens in the American economy affects economic conditions in their own country. More than 80% took this view in nine countries: Japan, South Korea, Australia, Britain, Germany, Egypt, Lebanon, Jordan and France. In regions throughout the world, people who believe the U.S. economy influences their own economy tend to say it is a negative rather than a positive influence. In six nations, 10% or fewer believed the U.S. economy positively affects their economy. Positive assessments were especially rare in several nations where anti-American sentiments have run high in recent years, such as Turkey (only 4% saw the impact as good), Argentina (4%), and Pakistan

[1] Robert Kagan, "Still No. 1" *Washington Post,* October 30, 2008.

(6%). In no country did a majority say the U.S. economy is having a positive effect.[2] Thus, while we believe that the United States remains the single most powerful nation on earth, we believe we can no longer dominate, much less dictate and expect others will follow. Or, as World Bank President Robert Zoellick reports after recently speaking to a senior Chinese economist, the economist responded that people in his home country — today's rising economic power — don't see the sky falling on the American economy. "They know its ability to turn around problems is really unmatched, historically," Mr. Zoellick said, quoting the economist about the United States. "At the same time, they ask themselves, 'Will the United States get at some of the root causes that could determine its real strength over the next 10 or 20 or 30 years?'"[3]

We believe there is a profound mood shift occurring, creating a great risk—but an even greater opportunity. We must seize it.

Your Administration will confront a world far different from that of your predecessors, one with a more complex global landscape, where U.S. financial pre-eminence may no longer be taken for granted. While the current credit crisis makes clear that nations and investors around the globe continue to believe that U.S. markets are relatively safer and more transparent, that perception has changed, even as the nation's debt has soared and raised longer term questions about the sustainability of the U.S. dollar, or as Douglas and Heidi Rediker write: "The so-called 'exorbitant privilege' of the United States to print the world's de facto reserve currency—and thus operate beyond the financial constraints that apply to other nations— may have become a bit less exorbitant."[4]

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[2] "Trickle-Down Global Economics: World Already Saw U.S. Influence as Negative," by Richard Wike, Associate Director and Erin Carriere-Kretschmer, Senior Researcher, Pew Global Attitudes Project, October 7, 2008.
[3] David Leonhardt, "A Power That May Not Stay So Super," *New York Times*, October 12, 2008.
[4] Douglas Rediker and Heidi Crebo Rediker, "Capital in the Capitol," October 21, 2008.

If anyone doubts the increasing importance of finance as a tool of foreign policy, one need look no further than Iceland, a NATO member, which last month announced that it was in negotiations for a 4 billion euro bailout from Russia. Iceland's prime minister was blunt: "We have not received the kind of support that we were requesting from our friends, so in a situation like that one has to look for new friends." While denied by the Icelandic government, there have been suggestions that one area of discussion is the possible use by Russia of a former–NATO military base on its soil. Others suggest that Iceland may be prone to more favorable consideration of future Russian claims to the resource-rich Arctic.

Even though Iceland ended up receiving a loan from the International Monetary Fund, the use of financial resources to achieve international goals is the latest example of a rising trend that might be termed the financialization of foreign policy. Similarly, Pakistan made overtures to China for a loan—a loan in return for which China surely would have extracted vital strategic benefits from a country that no only possesses nuclear capacities, but also a vital location. Again we are fortunate that Pakistan is in the final stages of working out a loan from the IMF. It is clear that the United States government is woefully unprepared for this convergence. An important lesson learned over the past several weeks is that U.S. strategic thinking about the foreign-policy considerations and consequences of finance and market issues has been inadequate.[5]

No one nation will be able to set, much less dictate the terms of new global economic and trade systems. Old systems, such as those set up in a previous generation at Breton Woods no longer reflect rapidly changing economic power and potential. We view this as an early and critical opportunity for change, new leadership, and smart power.

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[5] Douglas Rediker and Heidi Crebo Rediker, "Capital in the Capitol," October 21, 2008.

The crisis has demonstrated the importance of official sector capital flows, including Sovereign Wealth Funds. It has made clear the need for the international community to establish new international rules to address global trade and investments—and for our country to play a lead role in such development. Sovereign Wealth Funds, perhaps the most prominent subset of official sector capital flows, have been the target of considerable concern in the Congress and in the media, in part due to widespread negative reporting in the popular press a year ago surrounding the purchase and then forced sale by Dubai Ports World of cargo terminal operations. Our allies in Europe have been divided. Some emerging nations have taken exception to our concerns and appear to have built in at least a ten percent risk factor to long-term SWF investment in our country. In the midst of a credit crisis and recession, we do not believe we should be discouraging or erecting barriers against the return of our own capital resources.

These Sovereign Wealth Funds, whether from Norway, Alaska, China, or Dubai, are enormous and growing. Investments by sovereign-wealth funds have increased by 66 percent so far this year: Sovereign-Wealth Funds have already invested $25.5 billion in global mergers and acquisitions just in 2008. SWFs have been major investors in the U.S., especially, this year, in Citigroup and Merrill Lynch, as domestic credit and investment has deteriorated. With the continuing credit crisis in this country and the takeover of Fannie Mae and Freddie Mac, we clearly have a significant economic stake in continued credit access to international markets—as well as to greater transparency of foreign investment funds.

Our Working Group, working with key committees that deal with tax, trade, foreign affairs, the economy, and credit, notes growing recognition in the U.S. of the important and positive role SWF's can play, and, indeed, how important it is that the United States convey to SWF managers that we support and encourage SWF investment in our economy. We believe that the financial interdependence that sovereign wealth funds SWFs created between the West and the Arab world could help stabilize multilateral relations and promote economic development and political stability in the Middle East. We believe one of the most critical early initiatives of your Administration will be to develop policy initiatives in coordination with the International Working Group of Sovereign Wealth Funds convened by the IMF, which agreed to new voluntary principles and investment practices last month in Washington. These steps mark the most significant steps yet to bridge significant differences between funds with different histories, domestic political environments, and mandates. It comes, moreover, as the Organization for Economic Co-operation and Development is working on a parallel code of conduct for countries that receive sovereign fund investment.

As your new administration prepares to take the reigns, we believe it is important to recognize the rapid shift of Sovereign Wealth Funds from the periphery to the center of global financial markets, to note the enormous leverage these funds can have for stable, long-term investment, or for the purchase and ownership of critical materials in a world of waning resources. It will be especially vital to recognize the speed by which these funds have joined the ranks of other significant investor classes and that Arab, Chinese, and Russian sovereign wealth fund managers have become increasingly sophisticated as global investors. We have a significant stake not just in where and how these investments are made, especially since over 30 percent of total sovereign wealth accumulation appears to come from the United States in the form of trade deficits and Treasury borrowing. At a time of a credit crisis and recession, we ought not to penalize or discourage reinvestment in our own economy. We must balance concerns that some of these funds are now in positions to make strategic investments in industries that their governments perceive to be particularly relevant for the development and diversification of their national economies. In an era of finite and waning strategic commodities, wealth can provide considerable leverage.

This year, for the first time ever, Mike McConnell, the Director of National Intelligence, in the agency's annual threat assessment included financial issues as one of the leading security threats facing our nation, citing "concerns about the financial capabilities of Russia, China, and OPEC countries and the potential use of their market access to exert financial leverage to achieve political ends." That inclusion came well before the current global credit crisis. Therefore, in our view, these are issues that compel a fundamental structural overhaul of the way our government integrates financial issues into its strategic policy thinking. We urge your Administration to undertake a realistic appraisal of the global economy, noting the strengths and weaknesses of America's role in that economy and how other nations may seek to gain advantage through the financial tools increasingly at their disposal. In our relationships with international allies, competitors and potential adversaries, financial and economic components must be an integral part of our strategic and conceptual thinking.

Background

It was in the aftermath of World War II that the United States pioneered the international effort to construct global institutions to promote peace and prosperity. These included the United Nations, the World Bank, and the International Monetary Fund. They served our interests. Now, in the aftermath of this tectonic wealth shift to developing nations and a global credit crisis, we believe there is an opportunity for our country to take the lead in rethinking and recreating a new global financial infrastructure for the next half century or more.

The past eight years have witnessed a tectonic shift of wealth. Michael Mandelbaum, author of "Democracy's Good Name," writes that the current financial meltdown comes in the context of what has been "perhaps the greatest wealth transfer since the Bolshevik Revolution in Russia in 1917. Never has one generation spent so much of its children's wealth in such a short period of time with so little to show for it as in the current Administration. Never has so much wealth shifted from our nation to other nations. Thus it is that the fastest rising part of our federal budget is interest on our national debt—and an ever increasing amount of those interest payments are enriching foreign Sovereign Wealth Funds. Combined with our country's trade deficit, mostly from the cost of commodities, it is a reasonable guesstimate that up to one-third of the accumulated trillions of dollars in Sovereign Wealth Funds are from the United States. Therefore we have a critical stake in developing changed policies to develop innovative ways to repatriate these growing investment resources.

The importance of this issue to your new Administration cannot be overestimated in the present environment where private capital flows have almost completely collapsed and official sector capital flows have assumed even greater importance. Comprehensive international solutions will be necessary to address the spreading global financial contagion, increasing the importance of the development of comprehensive strategies to address not just SWF's but also the other sub-categories of official global capital flows, especially central bank holdings.

A quarter century ago, trade in goods and services accounted for roughly 90 percent of all cross border financial activity. No longer. Today, financial flows unrelated to trade now account for over 90 percent of cross-border activity. This is an astounding inversion. Investment flows not only dwarf trade flows, but also continue to grow almost twice as fast. While trade remains a significant component of the world's financial system, international investment is much more substantial. Two years ago, foreign purchases of long-term securities from American residents totaled

$52 trillion compared to $3.6 trillion in U.S. exports of goods and services.

The Old World and old global economic institutions recognize that the global economic power equation is shifting. Sovereign Wealth Funds are not a passing phenomenon, but rather a new, dynamic, powerful, and lasting feature of international financial relations. Addressing these new dynamics will be essential for a new Western economic diplomacy in what we believe should be our strategic interest in securing access to stable, long-term capital from the Arab world and other emerging economies now and in the future. Or, as President Nicolas Sarkozy warned, Americans cannot take for granted a world leadership role that comes with relatively little cost or sacrifice, as they have tended to do in the Clinton-Bush era. Leadership must be earned anew, and the costs cannot be simply passed down to future generations. Rather these inherent strategic considerations are likely to be permanent features of our global political, financial, and national security future.

Congressional Working Group on Sovereign Wealth Funds
Because of the importance of these unprecedented changes in global financial infrastructures and changes in wealth and the cross-cutting implications for U.S. leadership and across key federal intelligence, defense, foreign policy, financial institution, tax and other policy centers; our bipartisan Congressional Working Group on Sovereign Wealth Funds this year focused on the following key areas: SWF impact on the international financial markets; the geopolitical consequences of increased foreign government involved in private financial markets; how to repatriate a significant portion of shifted American wealth; and reciprocal treatment of foreign direct investment from the United States. Our broadest and greatest policy concerns were to address the tectonic outflow of U.S. capital. We wanted to ensure and support capital flows and open global markets. We needed to

weight the importance of changing from a unilateral to a multilateral approach. We wanted to pursue what U.S. steps are critical to retaining U.S. markets so they are perceived as the safest and most rewarding for long-term investment, and whether the U.S. should reconsider federal tax policies with regard to Sovereign Wealth Funds.

We were briefed by the International Monetary Fund subsequent to the organization's Santiago meeting. That new agreement, subsequently ratified in Washington, D.C. marks the first agreement between all major nations affected by this tectonic shift of wealth from our country overseas, with key implications for the U.S., which not only has one of the world's largest SWFs (Alaska, the world's 14th largest), but also has been a global beneficiary of Sovereign Wealth Fund investment. The new IMF guidelines cover issues such as transparency, governance, and accountability of these funds.

Based upon our meetings, presentations, and discussion, we believe the next 100 days constitute a critical and opportune moment to focus on the critical role that Sovereign Wealth Funds and other sources of official sector capital flows play in global finance and investment**.** Clearly, the current international financial infrastructure and practices are not adequate to the crises of today. As then-Senator Obama said in the second Presidential debate, we simply cannot address the 21st century financial crisis with 20th century institutions. The current crisis presents an opportunity for the United States to reshape how our government responds to these new economic realities. At a minimum, there must be significantly greater cooperation between the Treasury, Defense, and State Departments, and the national security apparatus. We believe the new Administration offers a critical time to incorporate smart policy as a recognition that foreign policy separate from financial policy is no longer an option.

Following are our recommendations for your consideration:

- President Bush and President-elect Obama need to communicate now that U.S. financial unilateralism is a relic. In this era of instant telecommunications and unfettered capital flows across borders, U.S. rescue plans will work in the long run only if they are accompanied by significant global regulatory reform and innovation.

Increasingly world leaders, including President Sarkozy and IMF Managing Director Strauss-Kahn, have called for high-level discussions to consider comprehensive international solutions to address the current crisis. Clearly, these topics will figure prominently in next week's IMF and World Bank annual meetings. There is growing recognition that we have outdated financial institutions that need revision in order to be effective in these times. This is a global crisis, and solutions necessarily must be multilateral and coordinated among all major international financial players. This necessitates that the participants at the table be expanded. It cannot simply be considered by the G-7 or other narrow group.

- We recommend the creation of a new Heads of State Summit, so that the heads of state of the G-20 are fully integrated into the critical forum to shape a 21st century reformed global finance infrastructure.
- President-elect Obama should call for such a global Heads of State conference in his State of the Union Address. A major focus for the conference would be to redefine: "What is the role of the International Financial Institutions in the current economic environment?" This focus would include the role of global official sector capital flows, including Sovereign Wealth Funds. Key issues would include broadening the discussion to focus on the underlying causes for the Sovereign Wealth Funds and their roles. For this effort to have hope of success, it is critical that this effort be

multilateral in approach. One of the challenges for such an international conference will be determining how widely to invite participants. Perhaps the G-20 group would be a good base, perhaps to supplement with a couple other important international participants. Several economists, such as Colin Bradford of Brookings, have suggested that the leaders of the G-20 (an "L-20") could be convened, along with their finance ministers.

- While the "Breton Woods II" title, as suggested by President Sarkozy and others, brings symbolic cache, it presents some complications as well. Marty Weiss and Jonathan Sanford of the Congressional Research Service suggest that it might be better not to use the "Breton Woods" label, since this would suggest possible reconstitution of the IFI's, and thus could prompt serious institutional resistance from the IMF and World Bank, among others. Indeed, casting the agenda too broadly risks a conference that drifts without a clear agenda, or concludes without concrete results (similar to the Doha Round's impasse over agricultural subsidies, or other UN multilateral negotiations). Clearly the Breton Woods institutions need new definition. But a full-scale reappraisal of the Breton Woods institutions would labor under the weight of widely different economic and financial perspectives – for example, spanning the differences among China and Abu Dhabi, Japan and Mexico, Britain and India and the U.S. (By contrast, Breton Woods worked six decades ago because the U.S. was the world's unrivaled superpower and was able to shape outcomes in a largely magnanimous way for the global economy. The international environment today, of course, is much different.

- There should be a reorganization within the Executive branch to bring the best and brightest talent together to address the strategic issues and how best to leverage our smartest power. We believe that the President's Council of Economic

Advisors, the Treasury, the State Department, and National Security Council need to be far more engaged in the world of international finance and economics—a competence which has, until now, been ancillary to its core capability. There must be an enhanced strategic role for the Treasury Department.

- The State Department, the Office of Policy Planning (OPP) reserves a hallowed space where policymakers from across disciplines come together to "anticipate the emerging form of things to come, to reappraise policies which had acquired their own momentum and went on after the reasons for them had ceased, and to stimulate and, when necessary, to devise basic policies crucial to the conduct of our foreign affairs." Members of the OPP act as a liaison with those outside of the government. The Treasury Department has no such space. Treasury's OPP, which currently functions as part of its office of communications, should be upgraded, refocused and should engage in a formal working relationship with the State Department's OPP to provide input on the long-term strategic implications of shifts in power in the world's financial system.
- The realignment should be structured to reach beyond Washington to serve as a liaison with market participants in the global financial system on matters relevant to U.S. foreign and domestic policy, including other states' use of capital to achieve political goals, the dollar's strategic role as a reserve currency and the America's role in the international financial system.
- For the departments and council to operate more cooperatively, it is important that each have the requisite level of cross-disciplinary expertise to pursue new avenues in international affairs. To that end, senior officials should have experience and training in *both* foreign policy and finance.

  - Given the enormity of this shift, hiring individuals with solely trade, as contrasted with broader financial, backgrounds is not ideal. For example, three out of four national security advisers for international economic affairs in the current administration were previously trade lawyers. In the next administration, relevant positions should be filled by individuals with not just trade experience, but with international investment or economics experience as well.
  - We also believe there will be a critical role for OMB and the House and Senate Budget Committees. With the coming explosion in Medicare costs, the federal budget deficit could eventually get so large that foreign investors would get spooked. They might then decide that other economies were safer bets and shift more of their lending there. Were that to happen, and the United States struggled to attract financing, the country would face a whole new crisis.[6]

- There should be a 21st Century international framework between investing and recipients nations that reflects the changing nature of the global market. A fragmented system of national policies is inefficient and in no nation's interest. This will be critical to efforts to challenge emerging nations in the Middle East and Asia to adjust their strategies and take broader responsibility for the stability of the global financial markets. Western governments should acknowledge the increased bargaining power of the Gulf countries and reach out in a constructive manner. They must also avoid policy decisions based on misplaced fear of foreign domination and populist sentiments. The rise of SWFs in the past years appears to have taken most, if not all, stakeholders in the global financial system by surprise. If, as financial analysts

[6] David Leonhardt, "A Power That May Not Stay So Super," *New York Times*, October 12, 2008.

suggest, SWF assets increase from the current US$3 trillion to US$12 trillion in the coming years, financial markets and the explicit and implicit norms and principles that govern them will be under even greater strain than today.

In response to public pressure, regulators on the international and national levels have begun to develop policies to provide new frameworks in which foreign investors, such as SWFs, could operate. The most important international initiative in this regard has been the International Working Group of Sovereign Wealth Funds convened by the International Monetary Fund (IMF), which sought to develop a voluntary code of conduct. However, this initiative has not prevented national regulators from developing their own policies with regard to foreign, sovereign investment. Rather, its results will compete with the outcomes of policy processes pursued on national and other supranational levels.

- Your Administration should make it a priority to assist the International Working Group to acquire a high degree of political legitimacy, anticipating the tremendous growth of SWFs in the mid-term future, further straining any new financial markets regime. Otherwise states will revert to national legislation in regard to regulating SWFs. The outcomes of these policy processes risk becoming a function of the domestic discourse between pragmatists and populists in the Western countries. Your Administration formally designate a U.S. Sovereign Wealth Working Group to coordinate and work with the International SWF Working Group and the Congress.

- Rather than focusing on defending Western assets from foreign investors, the West should acknowledge the foreign investors' new role and reach out to Arab SWFs in a constructive manner. The West should also consider the geopolitical consequences of tighter financial relations with the Arab world. Financial interdependence might help stabilize political ties between Western recipient economies and Arab investors. Arab strategic investments in Western assets can help diversify Arab economies and support the economic and social development agenda, thereby contributing to overall political stability in the broader Middle East.

- Use existing bilateral frameworks to engage directly with key SWF partners (i.e. Saudi Arabia, UAE) on issues of capital flows, investment, and an expanded "principles and practices" agreement. These engagements should strategically link, hone, and frame these discussions with reference to broader strategic arrangements, i.e. military cooperation and diplomatic engagement, such as the standing TIFAs with Qatar, UAE, and Saudi that call for establishment of bilateral Councils on Trade and Investment or the U.S.-Saudi Joint Commission on Economic Cooperation which was inaugurated in the 1970s to ensure petro-dollar recycling after the rapid rise in oil prices and related capital flow problem. USTR currently heads the trade and investment councils; we believe Treasury should at least a co-chair.

- We think the Council of Economic Advisors should quantify the outbound petrodollar flow in a regularly issued public report, so that there is greater recognition both in the Congress and among the American people of the relationship between America's energy policy and the country's financial health.

While the public and some Members of Congress have taken sometimes-demagogic positions about the potential nefarious impact of SWF's, there is increasing attention given to the major stabilizing roles that funds have provided. Notable in this regard was the Abu Dhabi Investment Authority's purchase of a large share of Citigroup in January, which prevented its collapse from bad real estate loans. Today, following the domino collapse in the past month of numerous former titans of the U.S. financial system, this SWF investment looks far more positive to even (former) critics of Sovereign Wealth Funds. Clearly, there needs to be much greater education of the public about the positive role that SWF investment in the U.S. economy -- how it can help create jobs and stabilize the U.S. financial system.

President Nicolas Sarkozy of France has suggested that European leaders set up sovereign wealth funds to buy stakes in crucial industries to shield them from foreign raiders. But Italy is already considering legislation to limit investments from foreign state funds, while Spain is actively courting such investments from oil-rich Arab countries. Mr. Sarkozy said that joint action by state investment funds would keep prominent European companies from falling into the hands of foreign investors. Mr. Sarkozy told the European Parliament in Strasbourg. "This might be an opportunity to create our own sovereign wealth funds."

- We recommend the creation of a U.S. Sovereign Wealth Fund (Just as Alaska imposes a stiff tax on the extraction of natural resources with a portion of the revenues dedicated to its SWF to ensure a legacy for its next generations after the oil is gone), so too the U.S. could levy a tax on any sales out of the Petroleum Reserve, and other natural resources. This would a) be consistent with your message that every American will have to pitch in to help us get through this hard time; b) be consistent with your message that instead of borrowing from, we ought to be setting something aside for our next generation; c) every penny we add to foreign imported energy sources will be critical towards reducing such reliance and reducing carbon emissions; and d) however small any federal tax were on energy imports, it would constitute a critical resource towards investment in our future.

- You should create an Interagency Working Group on Sovereign Wealth Funds: such an interagency working group should include representation from Members of Congress who have expertise on this issue. As noted above, the focus could be on overall sources of official sector capital flows, to include both the investments of central bank broadly and Sovereign Wealth Funds.

- The new White House should initiate a public education campaign to demystify Sovereign Wealth Funds and educate the public about the benefits of encouraging reinvestment back of our own resources in long-term, stable, capital investment. Currently popular views on the subject are typified by the Dubai ports example. Such an effort could bring needed balance to public awareness.

- It would be valuable for your Administration to conduct a briefing for Members and staff on the Hill, with focus on Sovereign Wealth Funds and official sector capital flows.

- We recommend an early review by your new Treasury Secretary of current federal tax policy of Sovereign Wealth Funds and other central bank funds and official flows of capital. Whether we should depart from this norm depends on several factors, including the external costs and benefits created by sovereign wealth investment, whether tax or other regulatory instruments are superior methods of attracting investment or addressing harms, and which domestic political institutions are best suited to implement foreign policy. Currently, investments by foreign state-owned entities, including strategic equity investments, are categorically exempt from U.S. tax. By contrast, portfolio investments by private foreign individuals and foreign corporations are taxed at rates as high as 30%, although this rate is often reduced by treaty, or, in the case of most capital gains or portfolio interest, exempt from U.S. tax. The tax preference makes the biggest difference with respect to equity investments in dividend-paying stocks. For example, when Morgan Stanley pays a dividend to a private foreign investor, a 30% tax is imposed and withheld at the source, unless a treaty rate applies. By contrast, when Morgan Stanley pays a dividend to the China Investment Corporation, the dividend is not taxed at all, so long as China provides a simple form certifying that it is a foreign sovereign within the meaning of section 892. The favorable tax treatment of sovereign investments allows sovereign investors to achieve a significantly higher after-tax return on equity investments than private investors. Our tendency is to oppose any tariffs or barriers to international investment or reinvestment back into our economy—already having warned in this White Paper that we believe there is already a current 10 percent risk factor with SWF investment in the U.S. as opposed to other countries. Nevertheless, we believe it important for your Administration to conduct an early evaluation and assessment.