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PUBLIC INTEREST COMMENT

Comments Encouraging a Broader Analysis of the Impacts of Proposed Restrictions on Outbound Investment

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Comments on Provisions Pertaining to US Investments in Certain National Security Technologies and Products in Countries of Concern
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I appreciate the opportunity to comment on the proposed rulemaking (NPRM) of the Department of the Treasury (Treasury) regarding outbound US investments in certain national security technologies and products in countries of concern. I am the director of the international trade program at the Mercatus Center at George Mason University. The Mercatus Center is a university-based research center whose scholars conduct independent analyses to assess economic policy, including government rulemaking and proposals, from the perspective of consumers and the public. My research focuses on international trade and its intersection with investment, globalization, and intellectual property rights, all in the interest of expanding the freedom of Americans to participate in the international marketplace while securing against national security risks. My comments reflect my own views and do not represent those of any party or special interest group.

I also work closely with the Mercatus Center's artificial intelligence (AI) program, which is dedicated to understanding the social benefits of AI and mitigating its risks. The Mercatus "AI Policy Guide," for example, explains fundamental components of the Artificial Intelligence ecosystem and describes policy questions raised by this technology, including matters of cybersecurity and supply-chain robustness.[1]

Below I provide comments on Treasury's cost-benefit framework for the proposed restrictions on outbound investment and suggest the consideration of two additional indirect costs:

1. Forgone investments due to dampening of incentives
2. Loss of US firms' global market access undermining US innovation and security

[1] "AI Policy Guide," Mercatus Center, George Mason University, last modified February 2023 (update forthcoming in August/September 2024), https://www.mercatus.org/ai-policy-guide.

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A potential decrease in foreign market revenue and investment returns could hinder US firms' capacity to reinvest in domestic research and development, potentially affecting those firms' innovation capabilities and ability to maintain a leading edge in these critical technologies including semiconductors, microelectronics, quantum information technologies, and artificial intelligence. Additionally, these indirect costs could undermine the national competitiveness and national security motivations of the rulemaking. I also suggest that the proposed rule's intent should be communicated clearly with trading partners in order to minimize the costs of forgone transactions. Finally, I provide a response to NPRM's question 5 on the distinctions between "notifiable" and "prohibited" transactions with respect to the products and technologies in the semiconductors and microelectronics and the AI sectors.

The Cost-Benefit Analysis Should Consider Two Additional Indirect Costs of the Proposed Rule

Outbound investment falls into three conceptual buckets: safe, unclear, and unsafe. These overlap, imperfectly, with the Treasury's proposed regulatory categories of "uncovered transactions," "notifiable transactions," and "prohibited transactions," respectively. An ideal rule would (a) allow for all safe investments ("uncovered transactions") with little or no compliance burden; (b) judge the unclear category ("notifiable transactions") on a case-by-case basis, in an objective, nonpoliticized manner that seeks to minimize direct and indirect costs; and (c) ban all unsafe ("prohibited") investments.

In both the main body and the Rulemaking Requirements section of the NPRM, Treasury considers both direct and indirect costs. The NPRM provides a helpful framework for estimating the costs and benefits of the proposed rule to the extent possible. The analytical framework includes examining indirect costs such as foregone returns on investment incurred when Treasury deems an intended investment to be a "prohibited" transaction. But indirect costs are also incurred—in all three proposed regulatory categories—if a firm abandons a potential investment opportunity from the start.

Two additional indirect costs in particular should be considered. The first one involves the forgone investments due to the proposed regulation's incentive-dampening effect on investors: When incentives diminish, firms abandon potential investment opportunities. The second cost is the loss of US industry's leading edge in critical technologies due to the forgone returns of *all* investments that did not occur—"prohibited" transactions and abandoned transactions—including forgone revenues, market access, market participation, and research and development expenditures. I discuss both in more detail below.

1. The new regulatory regime may dampen incentives for US outbound direct investment and lead to even greater forgone returns

The first indirect cost relates to the forgone returns on investments that would be deemed "uncovered" or "notifiable" if they would go through Treasury's approval process. That is, there are some investments that would occur but for the regulatory regime: Due to the actual or perceived costs of the regulatory regime, firms will abandon some transactions.

These incentive-dampening effects on investment are hard to quantify but should at least be acknowledged and taken into consideration to the extent possible when designing the new rule and implementation. The higher the actual or perceived cost burden of the regulatory regime, the greater the incentive-dampening effect.

Returns on outbound investment are not trivial. It is well known that US investment abroad tends to earn higher returns than foreign investment in the United States. Data from the Bureau of Economic Analysis show that the rate of return was 9.1 percent for US outward direct investment and 5.8 percent for foreign direct investment in the United States.[2] The ten-year averages were 8.9 percent and 5.1 percent, respectively.

2. Decreasing international market access undermines US innovation and security

The second indirect cost that should be considered relates to the follow-on effects of US outbound direct investments that maintain US firms' leading edge in these critical technologies. These costs relate to all US outbound investments that may not occur under the new regulatory regime, including the "prohibited" transactions and the transactions that would be deemed "uncovered" or "notifiable" but for the incentive-dampening effect (described in section 1 above).

There are multiple layers of economic activity spurred by outbound investment. For each outbound investment that does not occur there are potential lost net returns from forgone revenues, research and development expenditures, capital expenditures, exports, sales in the United States, and employment in the United States. One study found that a 10 percent increase in employment at foreign affiliates is associated with increases in the following: R&D spending in the United States (5.4 percent), capital expenditures in the United States (4.3 percent), exports from the United States (4.2 percent), sales in the United States (4.1 percent), and employment in the United States (3.9 percent).[3]

Maintaining robust access to foreign markets is crucial for US companies in these industries because it allows US companies to generate significant revenue that can be invested in their own research and development or that of other US firms in the industry. Access to the global marketplace and strong participation in the industry standards-setting processes go hand in hand with robust research and development expenditures. All these factors contribute to a virtuous cycle of growth and technological advancement, as well as the ability of US firms to maintain a leading edge in these critical technologies. In turn, US firms' leading edge in these critical technologies contributes to US economic and national security. Consequently, the rule could inadvertently harm the very innovation capabilities it aims to protect. This indirect cost should be considered as Treasury and relevant agencies seek to address national security concerns while maintaining US companies' global competitiveness and innovation potential.

Communicate the Rule's Intent Clearly with Trading Partners to Minimize the Costs of Forgone Transactions

Clear communication with trading partners can help minimize costs. In the case of China, a country of concern, the potential impact of the proposed rule could extend beyond China's borders, potentially affecting a significant portion of Asia. Asian countries are expected to contribute approximately 60 percent of global growth in 2024, and it cannot be taken for granted that they view China through the same geopolitical lens as the United States. These nations often have deep economic ties with China and may be reluctant to align fully with US policies they may perceive as being overly restrictive or

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[2] US Bureau of Economic Analysis, "Direct Investment by Country and Industry for 2022," Survey of Current Business, August 18, 2023.

[3] Gary Clyde Hufbauer, Theodore H. Moran, Lindsay Oldenski*, Outward Foreign Direct Investment and US Exports, Jobs, and R&D* (Washington, DC: Peterson Institute for International Economics, August 2013).

confrontational towards Beijing. As a result, US companies might face challenges in Asian markets beyond China if local partners, customers, or governments become wary of engaging with firms subject to stringent US investment screening processes. This ripple effect could significantly reduce US firms' access to crucial Asian markets, which are vital for generating revenue, collaborating around technology, and maintaining a competitive edge in rapidly evolving industries. Given that Asia represents a substantial portion of global economic growth and technological innovation, any restrictions that limit US companies' ability to fully participate in these markets could have consequences for their global competitiveness and long-term innovation capabilities.

Response to NPRM Question 5

Question 5: Is the line between the covered activities identified in the definition of notifiable transaction and those in the definition of prohibited transaction (with respect to the products and technologies in the semiconductors and microelectronics and the AI sectors) appropriately drawn? What are the potential consequences of the proposed scope of covered activities in the definition of notifiable transaction and prohibited transaction and how should the distinction between the two be adjusted, if at all?

AI chips and hardware demand a variety of materials and components to meet processing requirements. A strong AI ecosystem depends on supply chains that can consistently source and provide the necessary resources for the AI economy. To the extent that this new regulatory framework hinders the ability of US firms to participate in global value chains, the ability of US firms to maintain a leading edge in this critical technology area could be adversely affected.

Conclusion

These comments address Treasury's proposed rulemaking on outbound US investments in certain national security technologies in countries of concern. As a senior research fellow at the Mercatus Center, my comments above provide independent analysis focused on the impact of this rule from a consumer and public perspective, highlighting the balance between national security and economic competitiveness.

My comments highlight three points: (1) the proposed regulatory regime may dampen incentives for US outbound direct investment and lead to even greater forgone returns, (2) the proposed regime may lead to decreasing international market access that can undermine US innovation and security, and (3) communicating the rule's intent clearly with trading partners can minimize the costs of forgone transactions.

All else being equal, as the proposed regulatory regime's benefits to national security increase, the more likely the benefits will exceed the cost. As Treasury noted, however, the benefit of protecting national security is difficult to quantify. Some industry participants involved with informing Treasury and other government agencies may be incentivized to overstate the risks, while others may be incentivized to understate them. Hence, Treasury and other relevant agencies will need to rely on experts with intricate knowledge of the national security risks, a firm grasp of the benefit and cost analytical framework, and no monetary ties to the private sector.

Similarly, all else being equal, as the actual or perceived costs of rule compliance increase, it is more likely that the costs of the rule will exceed its benefits.

The incentive-dampening effect and forgone returns on investments are difficult to quantify, but there are existing estimates from government agencies and economic research of the contributions

of US multinational enterprises to the US GDP in terms of value added, capital investment, exports, employment, and productivity. It is reasonable to expect that a non-zero share of that contribution will be at risk from this new regulatory regime. It is ultimately the role of Treasury and other relevant agencies to determine what that share is, apply the appropriate benefit-cost analytical framework, and aim to minimize any potential harmful economic effects.

Thank you for the opportunity to provide this comment.