SOURCEREE

NATIONAL SECURITY NEWSLETTER

OCTOBER 2023

October 2023 Newsletter

National Security Investment Reviews

Issue 1: Strategy vs Execution – The Market Realities of Protectionist Economic Policy

<u>The Challenge of Rhetorical Support, Political Posturing, and the Theory of Industrial Policy</u>
Research by: John Lash, PhD

BLUF: **Protectionist economic and industrial policies, while politically expedient, may represent significant economic – and national security risk – in the longer term if many of the second and third order consequences of these actions are not considered.** Increasing collaboration, funding, and market access for areas of mutual interest – such as biotechnology, renewable energy, artificial intelligence, and quantum computing – presents an opportunity for the United States to work in partnership with China in a manner that would be in the best interest of both countries.

Issue: The U.S. must carefully consider the pros and cons of restricting Chinese market access to technologies. In some instances, when these restrictions are limited to focusing on key emerging technologies, the restrictions could help to protect national security. However, when the restrictions are not narrowly tailored or overly complex, these actions could stifle innovation, reduce productivity, and create negative economic externalities for U.S. businesses that will ultimately result in a decline in American superiority in key technological subsectors. Policymakers should carefully weigh the costs and benefits of different approaches and make decisions that are in the best interests of the country – ensuring that the risk to domestic innovation and technological superiority are considered on balance with the geopolitical rhetoric around espionage and intellectual property theft.

Realities: The following factors should be considered as part of the assessment for evaluating how protectionist economic (and/or industrial) policy impacts the markets operationally.

- **Economic Realities** – the impact of ***eligibility criteria and other requirements*** of industrial policy actions, *such as the CHIPS and Science Act (bipartisan bill signed into law in August 2022) providing $52B in funding for semiconductor research, development, and manufacturing*, ***create market-driven incentive questions for potential participants.***
- **In many cases, leading nonpartisan think tanks have noted that this micromanagement approach (e.g., the eligibility criteria and requirements for funding) is bad for competition and bad for business.**
    - *National Security "Guardrails" in the CHIPS and Science Act* – to ensure that CHIPS funding does not directly or indirectly benefit foreign countries of concern, the CHIPS and Science Act includes certain limitations on funding recipients, such as prohibiting engagement in certain significant transactions involving the material expansion of semiconductor manufacturing capacity in foreign countries of concern and prohibiting certain joint research or technology licensing efforts with foreign entities of concern. These limitations prohibit recipients of CHIPS incentives funds from using the funds in other countries; significantly restricts recipients of CHIPS incentives funds from investing in most semiconductor manufacturing in foreign countries of concern for 10 years after the date of award; and limits recipients of CHIPS incentives funds from engaging in joint research or technology licensing efforts with a foreign entity of concern that relates to a technology or product that raises national security concerns.[1]

[1] CHIPS and Science Act NIST FAQs. Retrieved from: https://www.nist.gov/chips/frequently-asked-questions

- *Upside Sharing of "Excess Profits" with the US Government* – Among firms that receive more than $150 million in funding, Commerce will require "Upside Sharing" of a portion of "excess profits" with the U.S. government. The notice defines excess profits as any cash flows or returns that exceed what firms submit for their projected cash flows as part of their application. The so-called "upside sharing" does not specify what portion of "excess profits" the government would take, but it would not exceed 75 percent of a recipient's direct funding award. One way to think about it is if a project is surprisingly successful, the government can claw back up to 75 percent of the awarded funds.[2]

- **Funding Realities** – the impact of ***actual government funding*** of industrial policy actions, *such as the CHIPS and Science Act (bipartisan bill signed into law in August 2022) providing $52B in funding for semiconductor research, development, and manufacturing.*
    - The Brookings Institute, a nonprofit nonpartisan American think-tank, released commentary in May 2023 indicating that the bold vision of the CHIPS and Science Act isn't getting the funding it needs to accomplish its ambitious policy goals.[3]
        - In spite of ongoing rhetorical support for the act's goals from many political leaders, neither the FY 2023 Consolidated Appropriations Act nor the Biden administration's FY 2024 budget request have delivered on the intended funding targets.
        - Instead, delivery on the CHIPS and Science Act paradigm can only be fractional as of now, *<u>with a $3 billion (and growing) funding gap for research and less than 10% of the five-year place-based vision funded to date</u>*.
        - In addition to decreased agency support, actual funding for what we call the "place-based industrial policy" in the CHIPS and Science Act is also coming up short, by even greater relative margins. Where the agency research funding gaps are a substantial restraint on innovative capacity, the diminished place-based funding is an out-and-out emergency. Examples:
            - ***Regional Technology and Innovation Hubs:*** Authorized at $10 billion over five years, the program received just $500 million in the FY 2023 omnibus—*<u>one-quarter of its authorized level for the year</u>*.
            - ***Regional Innovation Engines:*** This NSF program received $200 million in FY 2023 appropriations and would receive $300 million under the FY 2024 request. It was authorized somewhat differently than other CHIPS line items, receiving a joint $6.5 billion authorization over five years for the Engines along with NSF's newly authorized Translation Accelerators program. If one counts $3.25 billion as the five-year Engines authorization, then *<u>the program has received only about 6% of its authorization so far</u>*, or 15% if it receives the FY 2024 request level.

- **Scientific & Academic Realities** – the impact of reducing scientific collaboration with China and the quality of research in the U.S.[4]
    - Scientific research, and necessary scientific collaboration, is essential for innovation in key research areas such as healthcare and biotechnology.
    - Rising geopolitical tensions between the U.S. and China have had a negative impact on scientific research and collaboration, which could have long-term consequences for both countries – specifically with respect to productivity (measured in terms of citations as a

[2] Careful what you wish for: CHIPS subsidies require excess profits sharing. Retrieved from: https://taxfoundation.org/blog/biden-semiconductor-chips-act-subsidies/
[3] The bold vision of the CHIPS and Science Act isn't getting the funding it needs. (May 2023). Retrieved from: https://www.brookings.edu/articles/the-bold-vision-of-the-chips-and-science-act-isnt-getting-the-funding-it-needs/
[4] How U.S.-China Tensions Have Hurt American Science (Dec 2022). Retrieved from: https://bigdatachina.csis.org/how-u-s-china-tensions-have-hurt-american-science/

proxy for quality of research) and new publications (suggesting the decline in collaboration has a negative impact on quantity of research)
    - The tensions affect productivity as it means losing access to human capital, labs, and equipment that are crucial to research
    - Individual scientists that had collaborated with China previously saw a negative impact on the quality of their work, especially if they were of Asian descent and relied on NIH funding
    - Fields more affected by U.S.-China tensions (as found by the research team in the previous steps of the data analysis) also produced fewer new publications in 2019 and 2020 relative to the rest of the world
  - In addition to U.S. restrictions, the Chinese government has also carried out policies and unofficial actions that have also undermined academic and scientific exchanges.
    - This issue will become more widespread as China will likely seek to reinforce the trend of technological self-reliance.
  - Since 2013, China has been by far the most frequent international partner for American scholars' collaborations in the field of life sciences. However, since 2019 there has been a decline that is not observed in collaborations with other countries. The data shows that scholars with an established history of collaboration with China prior to 2014 saw a decline in productivity between 2018 and 2020. Three pieces of evidence link the decline in collaborations and productivity to rising geopolitical tensions:
    - Scientists of Asian background in the U.S. were more negatively impacted
    - Adverse effects in publications were spread across multiple U.S. institutions
    - Fields where NIH funding is more important and those with more U.S.-China collaborations experienced a larger decline in citations

The De-Risking, Collaborative, Path Forward: During U.S. Commerce Secretary Gina Raimondo's September 2023 visit to China, the Secretary addressed concerns regarding national security, U.S. labor, and U.S. business. The "***market realities***" discussed during this visit were apparent:

- The U.S.-China commercial relationship, which is very large and growing, and ***underpins hundreds of thousands of U.S. jobs.***
- Export controls are about national security, ***not about gaining an economic advantage***.
- ***The U.S. will still continue to sell billions of dollars of chips a year to China***, because the vast majority of chips that are made are not the leading edge, cutting edge.
- Export controls reflect a nuanced and complex policy, ***selling certain chips to China will ultimately generate revenue for American businesses to invest in further research and development***.

There is little doubt that action must be taken to ensure that the United States remains competitive in global markets; however, policymakers must also consider the impact on businesses that operate within the U.S. – their ability to compete and sell globally, to earn profits to reinvest for further innovation, and to attract / retain talent globally.

Policymakers should seek to minimize the cost on U.S. business by focusing on restrictions only on the most critical technologies, exempting certain types of collaboration from restrictions, funding the necessary "industrial policy" actions, and building trust with China to collaborate on issues of mutual interest / benefit.

Issue 2: Does New CFIUS Data Show U.S. Constraints On Foreign Investment Intensifying?

Source: https://www.forbes.com/sites/harrybroadman/2023/09/30/does-new-cfius-data-show-us-constraints-on-foreign-investment-intensifying/amp/

Considerations:

Washington's executive branch interagency Committee on Foreign Investment in the U.S., "CFIUS", the entity that oversees the country's national economic security screening of inbound foreign direct investment, on which I served during my tenure in the White House, is required by statute to submit to Congress and publish an annual report cataloging decisions it took the preceding calendar year.

Since the Committee's operations are confidential—as they should be, inasmuch CFIUS handles proprietary data—the published reports are pored over by companies, investors, policymakers, and other economic stakeholders both in the U.S. and abroad trying to glean insights from the treasure trove of data contained in the reports about Washington's disposition toward foreign capital inflows.

As has been the case for previous CFIUS' Annual Reports, regrettably the data routinely presented by CFIUS and the agency's "analysis" of them in its newest report provide scant economically meaningful information about CFIUS' actions and the true nature of U.S. policy towards foreign direct investment, including how the policy regime has evolved, not just during the prior year but compared to earlier periods since the report contains historical information.

To be sure, providing such data can be done without running afoul of security and confidential protocols. Omitting them means the report lacks credible information upon which investors make decisions—to the detriment of the economic prospects of the U.S. As such, CFIUS likely conveys a distorted and perhaps even an erroneous portrait of the stance of U.S. foreign investment policy in its reports.

Indeed, even if CFIUS' decisions amount to U.S. policy becoming more welcoming to foreign direct investment—whether in certain sectors or even writ large—the absence of credible economic information presented by CFIUS can amount to engendering a chilling effect on the nation attracting such investment.

Even taking into account such constraints, however, the annual reports CFIUS submits to Congress and publishes comprise "blinded" data that not only overly summarize the Committee's decisions and other activities it undertook for the preceding calendar year, but actually serve to obfuscate generating clarity in U.S. policy toward foreign direct investment.

Most telling in this regard is the reports focus on CFIUS's disposition by number of transactions it annually reviews—whether voluntarily submitted to CFIUS by the involved parties or proactively assessed by the Committee. Not surprisingly, such data do not contain information about the financial value of the transactions in question—suitably blinded. For example, what percentage of the total dollar value of inbound foreign direct investment in the U.S. was cleared? Blocked? Or subject to CFIUS mitigation measures?

By the same token, CFIUS does not provide an assessment of the nature of the risks it mitigated through its decisions, and perhaps even a rough monetary assessment of the risks averted.

The result? There is little information systematically available on which economically meaningful judgments can be made as to the risks CFIUS' actions have mitigated; or conversely, to evaluate whether CFIUS' actions mitigating or blocking a foreign investment have prevented the realization of otherwise additional value within the U.S. economy, such as the production of goods and services and/or the creation of new jobs, and if so, enable a determination of the scale and composition of such outcomes.

- CFIUS' tabulations of its actions by number of deals regardless of their financial value prevents economically meaningful assessments of:
    - The extent to which CFIUS' actions per se have been making U.S. policy toward foreign investment more stringent or less restrictive year to year;
    - Whether particular sectors in the U.S. have been easier or more difficult for foreign investors to participate, and if so, to what degree, on what basis, and an estimate of the relative magnitude of the value of national economic security risks mitigated;
    - Whether firms from various source countries versus others have had an easier or more difficult time entering the U.S. market in particular sectors; and
    - The extent to which the U.S. foreign investment policy regime has become more or less inviting than those of competitor nations—presumably a key performance indicator for policymakers who believe cross-border capital investment is source of domestic economic growth.

Governmental entities charged with mitigating foreign investment risks may well have a natural inclination to tout the number of deals they had to review. Conversely, a "record" may have been set because the overall level of U.S. foreign direct investment inflows rose significantly. By the same token, was the record set due to a change in the sectoral composition of foreign investment toward more sensitive sectors?

CFIUS gives little, if any, insight on the answers to such questions. Yet they are fundamental in understanding what factors in the U.S. foreign investment policy framework are most potent in affecting foreign investors' decisions on whether to deploy capital in the U.S. economy.

The second is that the annual report notes that "CFIUS continues to clear a majority—58 percent of distinct transactions." Frankly, it is hard to determine the economic meaning of this figure and what it indicates about the nature of the judgments made by CFIUS and hence the stance of U.S. policy toward foreign direct investment.

Would the alternative but equally valid formulation—"42 percent of distinct transactions were not cleared"—convey a different message?

Regrettably, the Committee's portrayal of these two statistics is not an academic matter. Like other economies, the U.S. competes with other countries to attract capital from abroad. You can be sure investors will struggle trying to decipher the value of this CFIUS report.

Issue 3: McHenry at CFIUS Hearing: We Must Use Time-Tested Tools to Get Tough on China—Not Novel Concepts

Source: https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408966

Considerations:

Washington, September 13, 2023 -

The House Financial Services Committee, led by Chairman Patrick McHenry (NC-10), held a hearing to conduct oversight of the Committee on Foreign Investment in the United States (CFIUS) and examine other efforts to strengthen America's national security.

Read Chairman McHenry's opening remarks as prepared for delivery:

"Today, we will conduct oversight of the Committee on Foreign Investment in the United States—or CFIUS—and examine efforts to strengthen our national security.

"Thank you, Assistant Secretary Rosen, for being here and I look forward to your testimony.

"CFIUS operates under a dual mandate: to address national security risks in foreign investments and maintain the United States' commitment to an open investment climate.

"Five years ago, Congress enacted the most far-reaching changes to CFIUS in a generation. This legislation—the Foreign Investment Risk Review Modernization Act, or FIRRMA—extended CFIUS's jurisdiction to certain non-controlling investments, as well as real estate transactions near sensitive government sites.

"FIRRMA also made operational updates so that CFIUS officials could complete investment reviews more effectively. This included creating the position that you now occupy, Mr. Rosen.

"These reforms were carefully tailored to legitimate national security risks. Yet, at the same time, FIRRMA underscored the United States' longstanding embrace of foreign investment.

"In addition to reforming how we look at inbound transactions, Congress also strengthened national security through a major outbound policy, the Export Control Reform Act.

"This was the first long-term reauthorization of export controls in nearly four decades. This legislation, which passed with FIRRMA, now serves as the legal basis for our export controls against adversaries like China and Russia.

"Like all previous CFIUS laws, FIRRMA recognized that an outside investor may pose a risk to the country receiving investment. That's common sense.

"But now the Biden Administration is proposing to use CFIUS to regulate Americans' investments into China. That's nonsense. Congress has repeatedly dismissed this idea, and for good reason.

"If you oppose Beijing's state-owned enterprises, you want more Western investment in China—not less.

"If you are concerned about Chinese technology companies, you want more Americans in control of them—not fewer.

"And if you want to expand the reach of U.S. sanctions and export control laws, you want Americans in Chinese boardrooms who are required to comply with these laws—not CCP cronies and Saudi princes.

"This is precisely why Xi Jinping has been attacking Western influence in Chinese companies. The Biden Administration's outbound investment proposal will only help him achieve that goal more quickly.

"Since it was first floated a few years ago, the premise of an 'outbound CFIUS' has lacked the basic facts necessary to warrant such a move. You hear of 'loopholes' and 'gaps,' but not a single real-world example.

"In May, I sent a letter to Secretary Yellen asking for the data to justify outbound restrictions. Not one of my questions was answered. That's because there is no data to begin with.

"Mr. Rosen, you have an unenviable job. Now that outbound regulations have been announced by Executive Order, Treasury must seek to avoid a disaster in its implementation.

"You know as well as I do that we must use time-tested tools to get tough on China—not novel concepts.

"We need clear rules of the road and action based in data and facts—not political gamesmanship.

"As I have said all along, to outcompete China we cannot become more like the Chinese Communist Party. We must double down on our commitment to free people and free markets.

"Taking concrete actions is the toughest approach to countering the generational threat posed by the CCP.

"I look forward to hearing from you today about how we can work together to achieve that shared goal."