State-owned Enterprises and the Trade Wars

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Introduction: A growing role for SOEs? ¹

During the last decade, a growing perception in some quarters has been that international competition is no longer fair, in a way that undermines the case for free trade. In some markets such as steel and aluminium, SOEs are key players and Chinese SOEs have contributed to large global overcapacity. SOEs have therefore come under attack as one of the potential “culprits” of unfair competition. In this brief, we examine: the role of SOEs in international competition; the international rules in the field; and the current discussions about trade policy reforms related to SOEs.

In the 1990s, SOEs were oriented primarily towards domestic markets or concentrated in declining or predominantly public, non-commercial, sectors. More recently, however, SOEs were increasingly competing with private firms in international markets, trading across borders and establishing themselves abroad:

• Among the 2000 largest firms in the world (on the Forbes Global list), the share of firms majority-owned by the state is on the rise and reached 14% in 2012-2013.

• Among the 500 largest firms on the Fortune Global list, OECD (2013) found an even larger share of SOEs (19% in 2011), and from 2000 to 2011, the SOE share increased from 6% to 20% for revenues and from 19 to 30% for employment.

• SOEs are also increasingly active in international mergers and acquisitions (OECD 2016).

Many of the world’s largest SOEs originate from the large and fast-growing emerging economies. Kowalski et al. (2013) found that 70 out of the 204 majority SOEs among the 2000 world’s largest companies in 2012 were owned by central or local governments of China, followed by India (30), Russia (9), the United Arab Emirates (9) and Malaysia (8). Advanced

¹. In this brief, we use the term SOEs more broadly about firms being owned or controlled by, or otherwise linked to, the state. This distinction matters since ownership is but one form of state control observed.
country SOEs originated mainly from Norway, France, Ireland, Greece and Finland.

The increased presence of SOEs in international markets include is partly due to globalisation of economic activity in general, including SOE participation in global value chains), and the fast growth of countries with large SOE sectors, like China. Another driver has been the partial privatisation of state-owned sectors in (formerly) centrally planned economies and in some advanced economies. There have also been cases of increased policy-driven state intervention in domestic and international markets, in the aftermath of the 2008-09 crisis.

Existing policy approaches
Most countries have domestic regulations regarding governance of their SOEs (e.g., national company laws, competition and state aid regulations, etc.). Norway, one of the countries with largest SOE sectors among the OECD economies, has in place a range of policies which are considered state of the art when it comes to corporate governance of SOEs. However, domestic regulation can only go so far in addressing anti-competitive effects of SOEs in international markets. But policy views diverge across countries on the rationale for preferential treatment or advantages afforded to SOEs. Worse, national governments may simply use SOEs to pursue strategic economic and political objectives to the detriment of other nations. Hence there are strong reasons for international policy co-ordination, along with conflicting perceptions. In the following, a brief overview of international regulation is provided (for more detail, see e.g. Kowalski and Perepechay 2015, Kowalski and Rabaioli 2017, or OECD 2016).

OECD SOE Guidelines
The OECD Guidelines on Corporate Governance of State-owned Enterprises (OECD SOE Guidelines thereafter) list a large number of principles implementation of which would go a long way towards maintaining a level playing field in international markets. In particular, the chapter State-owned enterprises in the marketplace, recommends the maintenance of a level playing field among state and privately-owned incorporated enterprises engaging in economic activities. Specific recommendations to achieve this objective include: separation between the state’s ownership function and other state functions that may influence the conditions for SOEs; standards of transparency and disclosure regarding costs of SOEs combining economic activities with public policy objectives and funding by the state of the latter; requirements to ensure SOEs face market-consistent access to financing; and competitive behaviour of SOEs as both bidders and procurers in public procurement (OECD, 2015).

However, the Guidelines are not binding and their implementation is not regularly monitored. Even across the OECD countries, policies in areas covered by the Guidelines vary considerably.

WTO
The WTO law follows an ownership-neutral approach, which focuses on disciplining market-distorting actions of states regarding any enterprise. It includes several disciplines which can be used by WTO Members to curb anti-competitive behaviour by states involving SOEs, to the extent they affect international trade. The WTO Agreement on Subsidies and Countervailing Measures (ASCM), for example, prohibits or disciplines various forms of subsidies or trade-distorting financial preferences. These provisions largely address one of the key concerns raised in the context of SOEs—subsidisation, at least as far as goods trade is concerned. WTO also disciplines actions of SOEs which act as ‘extensions’ of governments, for example if an SOE subsidises another firm one way or other. When an SOE can be seen as acting as a public body is food for the trade lawyers, and an issue for WTO reform debates.

Preferential Trade Agreements (PTAs)
Some newer PTAs adopt the WTO philosophy of focusing on disciplining trade-distorting actions of the state, but they explicitly define SOEs and require that these are held to the same standards as governments themselves. Two interesting recent examples are the EU-Vietnam FTA and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), that was negotiated by the 11 remaining nations after the United States withdrew its signature of the TPP (Trans-Pacific Partnership). CPTPP includes most of the provisions of TPP and its SOE chapter. USA withdrew from the TPP but has similar provisions in its new agreement with Canada and Mexico.

The CPTPP defines SOEs not only based on ownership shares (>50%) but also voting rights and the power to appoint a majority of members of the board of directors. It defines the commercial activities of SOEs and provides specific definitions of advantages which may not be granted to SOEs and by SOEs in the form of non-commercial assistance. It also requires of SOEs to follow commercial considerations when they engage in economic activities, while also specifying extensive transparency provisions. The treaty also covers investment and extends the provision of non-discriminatory treatment by SOEs of foreign goods and services suppliers both in their sale and purchase activities to non-Parties.

Investment treaties and national regulations related to inward foreign direct investment
In the area of international investment there is no equivalent of the WTO and the bilateral investment treaties typically do not contain obligations on SOE investors or their home states not to engage in level playing field-distorting practices. They also rarely contain provisions that would ensure non-discrimination against SOEs. This is why we have seen an increase in new SOE-focused disciplines in national inward investment regimes. In a number of cases, this has led to a refusal of approval of FDI by SOEs. Recently, the EU adopted provisions for stricter application of the so-called “national security” or “net benefit” tests as well as stricter approval requirements for SOEs investment overall or for such investment in “strategic” sectors.

2. These principles concern: legal and regulatory frameworks; principles of the state acting as an owner; equitable treatment of shareholders; behaviour in the market place; relations with stakeholders; transparency and disclosure; and the responsibilities of the boards of state-owned enterprises.

3. Still, there are some departures from this rule, for example in WTO accession protocols of China and Russia.
What are the concerns about trade and Investment of state-owned enterprises?

The main concern is that SOEs, because of their relationship with governments, may be vehicles of state-induced trade distortions arising, among others, from:

- Financial or in-kind state support to and from SOEs, state banks or other (state-backed) financial institutions;
- Exemptions and preferential regulatory treatment of and by SOEs;
- Explicit and implicit guarantees to and by SOEs;
- Preferential treatment in public procurement.

But such advantages can also be granted to privately owned enterprises, and can receive and extend to other economic actors, upon instruction from the government, subsidies or other market-distorting advantages. Hence state ownership does not inevitably imply the existence of state-induced market distortions, and there is a debate whether or not state ownership is a relevant criterion that can help reduce the state-induced market distortions and ensure a level playing field.

Evidence

Hard evidence on the extent to which SOEs actually benefit more from government-granted advantages as compared to their private peers is limited. One OECD study assessed performance and financing structure of large SOEs, finding, among others that SOEs paid lower interest rates on their debt only in the oil and gas sector. They did nevertheless benefit from unusually favourable positions in their home market (monopoly power and ability to charge higher prices) in many sectors. A survey of around 160 firms conducted in 2015 revealed also that SOEs were reported to benefit more than their private peers in terms of all the forms of preferential treatment discussed above.

Some evidence on the existence of advantages granted to SOEs has also been collected in the context of specific industrial sectors. In steel, a sector struggling with overcapacity, in recent years questions have been raised about the extent to which state involvement may have aggravated the overcapacity crisis in the sector. While today the sector is largely dominated by private producers, it has been estimated that in recent years SOEs accounted for more than one third of the total planned or underway capacity of all proposed future steel investment projects. Chinese SOEs accounted for 41% of the additional capacity while India and Iran accounted for, respectively, 19% and 6%. Two significant WTO dispute cases concerning steel involves a state-owned bank and a state-owned mining corporation.

Over the last two decades the aluminium sector has seen China emerging as the leading producer leading to concerns about excess capacity and impact on aluminium prices and producers. A recent OECD study estimated that while in general the fluid relationships between governments and aluminium firms complicated the assessment of form and scale of government support in the sector, the vast majority of the USD 70 billion support for the seventeen largest aluminium firms in the 2013-17 period was provided by China’s state-owned banks to Chinese aluminium SOEs. Private Chinese firms also benefitted from support by Chinese state-owned banks.

Conclusions

Following the increased presence of SOEs in international markets, the current discussions of unfair trade practices have naturally involved the role of SOEs. Some of the emerging market economies, particularly China, have large state sectors and the actions of internationally-active SOEs and their potential violations of the WTO rules are likely to be watched more and more closely. New disciplines are likely to be developed.

In the area of international trade, developments are more predictable thanks to the WTO rules which already discipline the main forms of discriminatory behaviour by SOEs and, at the same time, protect market access rights of market-oriented SOEs. It is likely that actions of owners or managers of SOEs and SOEs themselves will face a closer scrutiny in the WTO. Given the recent interest in SOEs in the context of recent or ongoing bilateral or regional trade negotiations, new PTAs are also increasingly likely to contain SOE-specific provisions.

Potentially less orderly policy developments could unfold in the area of international investment where there are no multilateral rules that would set obligations on SOE behaviour as investors while providing them at the same time with non-discriminatory market access. SOE-related provisions in countries national inward FDI regimes involving economic benefits or national security tests have been a popular approach recently and this trend is likely to be continued, also amidst the growing concerns about the role of states and FDI in international technology transfer.

Improved transparency and disclosure requirements are dimensions that cut across all the different angles and perspectives on SOEs discussed recently. These are likely to be the primary area of interest for policy makers who want to first learn more about the actual market effects. Different transparency-related monitoring exercises related to SOEs may be launched in the context of the WTO, specific PTAs, the OECD, or unilaterally by countries which want to ensure that their SOEs face as little hurdles in international markets as possible or are concerned about their effects in international markets.

5. See Kowalski and Perpepechay (2015) for a detailed description of the survey and its results. OECD (2016) also recorded similar concerns in survey administered to policy makers.
6. See Kowalski and Rabaïoli (2017) and references therein.
7. These are, respectively, DS379 US – Anti Dumping and Countervailing Duties (China) and DS436 US – Countervailing Measures on Certain Hot-Rolled Carbon Steel Flat Products from India.
Bibliography


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