

# CHAPTER 12

## State-Owned Enterprises and International Competition: Towards Plurilateral Agreement<sup>1,2</sup>

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*Concerns about the behaviour and role of Chinese state-owned enterprises (SOEs) is a source of rising geo-economic tensions. This is not a matter pertaining only to China. Many World Trade Organisation (WTO) members, including European Union (EU) member states, have SOEs. Recent bilateral and regional agreements signed by China, the EU, and the United States (US) include provisions on SOEs and offer a basis on which to build, suggesting the possibility of negotiating a plurilateral agreement among major WTO members. Preparing the ground for such an effort calls for developing a solid evidence base on the prevalence of SOEs, their economic performance, and associated cross-border competition spillover effects.*

### INTRODUCTION

SOEs may be used to provide essential goods and services, or as an element of industrial policy or development strategy. Insofar as SOEs are used as instruments in the pursuit of economic development goals, they will generally affect competition on markets, and thus may have repercussions for international competition. The prospect of cross-border spillovers provides a rationale for rules to be included in trade agreements. Trade agreements can act as a commitment device for beneficial policy reforms by leveraging the interest of trading partners to reduce the adverse cross-border spillover effects of large SOEs (Brou and Ruta 2013). Trade agreements can also provide a mechanism to ensure a policy framework that supports competitive neutrality and improve the availability of data on the prevalence and operation of SOEs.

The stylised fact here is that increasingly, preferential trade agreements (PTAs) go beyond the WTO in including provisions that address the potential anticompetitive implications of the operation of SOEs. Concerns about the behaviour and role of Chinese SOEs are a

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source of rising geoeconomic tensions. While this is not a matter pertaining only to China, as many other WTO members have SOEs, the size and international presence of Chinese SOEs puts the spotlight on China. Recent bilateral and regional agreements signed by China, the EU, and the US, include provisions on SOEs and offer a basis on which to build. Preparing the ground for such an effort requires developing a solid evidence base on the prevalence of SOEs, their economic performance, and associated cross-border competition spillover effects.

The structure of the chapter is as follows. Section 1 presents some stylised facts on SOEs and discusses why SOEs matter for the trading system. Section 2 discusses the coverage of SOEs in the WTO and recent trade and investment agreements. Section 3 summarises two alternative – perhaps complementary – paths to bolster disciplines on SOEs in the WTO and argues that a first step could be for China and the EU to take the lead in the WTO to improve the information base on SOEs as a first step towards negotiating a plurilateral agreement under WTO auspices. Section 4 concludes.

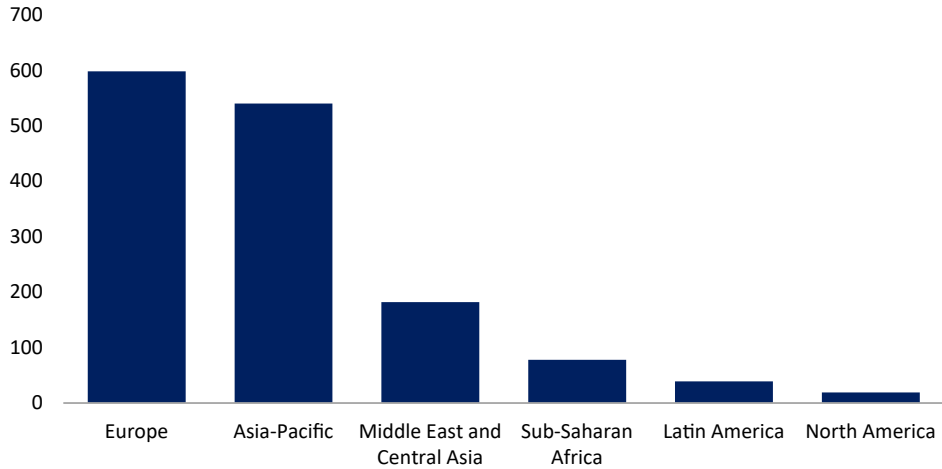
## 1. WHY SOES MATTER FOR THE TRADING SYSTEM

An essential element of China's development strategy is direct engagement of the State in the operation of the economy through SOEs. At the same time, China's economy has a strong market orientation (McMillan and Naughto, 1996, Lardy 2014) and relies heavily on international trade (Branstetter and Lardy 2008, Zheng 2004). Chinese SOEs operate on both the Chinese and international markets and engage in vigorous competition with other firms in their respective sectors, whether Chinese or foreign. Insofar as SOEs engage in commercial activity and benefit from state support that provides them with a competitive advantage (e.g. benefiting from lower cost of credit, guarantees or transfers from the government to cover losses) the operation of SOEs may pose a problem for the trading system by tilting the playing field in their favour. A key worry in this regard has been an increasing emphasis on SOEs by China (Lardy 2019) and the opaque nature of potential subsidies provided to, or by, SOEs, which is distinct, at least in principle, from the direct fiscal transfers that are associated with government subsidy programmes.

Concerns about the potential for SOEs to distort competition reflect views that SOEs are effectively subsidised (through soft loans, guarantees, preferential access to factor inputs other than directed credits, such as energy and land) and may indirectly subsidise downstream firms in both home and foreign markets through below-market pricing for their goods and services. In addition, SOEs may benefit from protection from foreign competition (e.g. reflected in FDI restrictions, joint venture requirements, preferential access to public procurement markets, etc.). From a global competition perspective, what matters is the extent to which SOEs are large and operate internationally. Europe and the Asia-Pacific region dominate the global SOE landscape (Figure 1). SOEs in other regions tend to be less multinational, suggesting more of a focus on local markets. Chinese non-

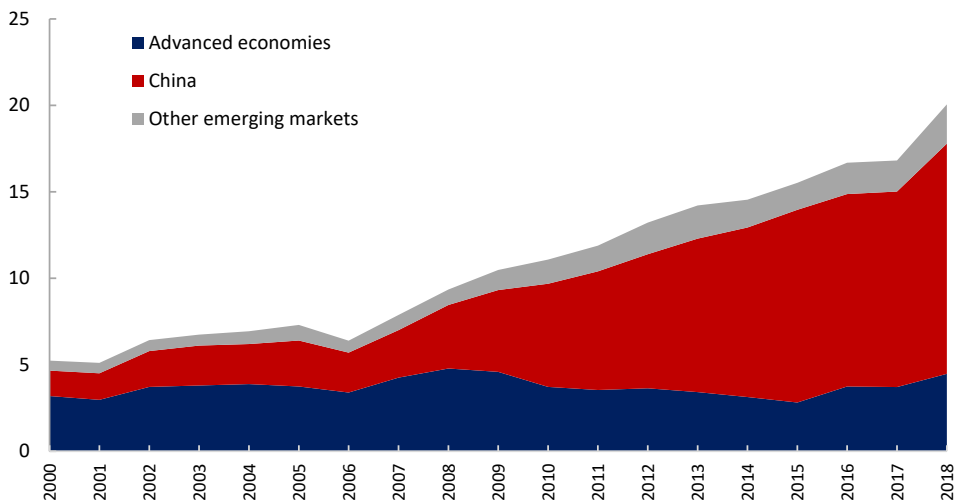
financial SOEs account for a large share of the Asia-Pacific total. They have become steadily larger in the last two decades, reflected in a rising share of the total assets held by the largest 2000 firms globally (Figure 2).

**FIGURE 1 NUMBER OF MULTINATIONAL SOEs BY REGION, 2019**



Sources: IMF (2020).

**FIGURE 2 SHARE OF NON-FINANCIAL SOEs IN TOTAL ASSETS HELD BY LARGEST 2000 FIRMS GLOBALLY (%)**

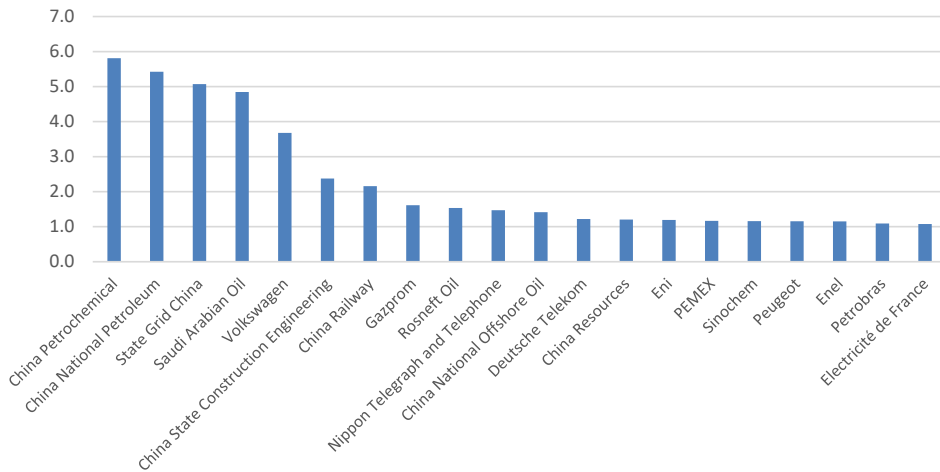


Sources: IMF (2020).

An estimated 22% of the world's largest 100 firms are effectively under state control (OECD 2016). In 2018, Chinese firms accounted for almost one-quarter of the largest 500 firms globally.<sup>3</sup> The five largest Chinese companies on the list are all SOEs. Figure 3 reports the 20 largest non-financial global companies with state ownership by revenue share in 2018. The list includes eight Chinese SOEs, as well as several large European companies and state-owned natural resource/energy companies in different parts of the world. These companies differ greatly in terms of public ownership. In some instances, this is low – e.g. Peugeot, with public ownership following its merger with Fiat currently standing at 6.2%, in others it is 100%. This illustrates that any effort to negotiate new rules for state-owned or controlled enterprises must consider the criteria that determine the coverage of an agreement. This should go beyond ownership and include factors associated with the potential for significant cross-border competition spillovers.

There has been relatively little research on the effects of SOE operations from a competition perspective. To some degree, potential cross-border spillover effects can be inferred from economic studies of the performance of SOEs relative to comparable privately owned and managed firms in their sectors. Empirical evidence for Chinese SOEs documents that they have a lower cost of capital (reflected in lower interest rates on their debt) and that privatised SOEs continue to benefit from government support relative to private enterprises (Harrison et al. 2019, Wood 2019). More generally, cross-country evidence suggests that SOEs are less profitable and less productive than private firms in their respective sectors (see Kowalski et al. 2013, IMF 2020).

**FIGURE 3 TOP 20 GLOBAL NON-FINANCIAL COMPANIES WITH STATE OWNERSHIP**



Source: IMF (2020).

Note: (percent of revenues relative to total revenues of largest 2000 firms).

3 See <http://fortune.com/global500/list/filtered?hqcountry=China>.

## 2. THE COVERAGE OF SOES IN THE WTO AND TRADE AND INVESTMENT AGREEMENTS

The WTO Agreement has few obligations on SOEs. The General Agreement on Tariffs and Trade (GATT) Article XVII on state-trading enterprises (STEs) dates back to the 1940s, and addresses a specific type of SOE: ‘Governmental and nongovernmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports’.<sup>4</sup> Note that there is no mention of ownership. What matters is exclusivity or special privilege. The right of WTO members to maintain or establish STEs, or to offer exclusive privileges, is not limited. The basic obligation imposed on STEs is to make purchases or sales on a non-discriminatory manner (Article XVII:1a), which requires that STEs make purchases or sales solely in accordance with commercial considerations (Article XVII:1b). Case law has interpreted these provisions as simply requiring non-discrimination, i.e. if STEs do not act in accordance with commercial considerations but this does not result in discrimination there is no violation of Article XVII.<sup>5</sup> China, when acceding to the WTO, agreed to considerably reduce the use of STEs operating in industrial goods and to eliminate import STE monopolies for agricultural products such as wheat, rice, and corn. Similar commitments were undertaken by Vietnam (Hoekman and Kostecki 2009).

The WTO Agreement on Subsidies and Countervailing Measures (ASCM) is more recent than GATT Article XVII, reflecting the situation (and thinking) prevailing in the 1990s regarding subsidies. The ASCM covers subsidies granted to any type of firm, independent of ownership. The definition of covered subsidies includes financial contributions provided by ‘any public body’ and not just government agencies. Under China’s Protocol of Accession (and the Report of the Working Party) China made commitments that go beyond the ASCM, including binding commitments on SOEs and state-invested enterprises (SIEs). Examples are provisions in the protocol stating that subsidies provided to SOEs will be regarded viewed as specific if the SOE(s) are the main recipients or the amounts granted are large, and that purchases by SOEs/SIEs will not be considered government procurement (and thus are subject to the national treatment rule). These are China-specific obligations. No such requirements apply to SOEs from other WTO members.

4 Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994. At [https://www.wto.org/english/docs\\_e/legal\\_e/08-17\\_e.htm](https://www.wto.org/english/docs_e/legal_e/08-17_e.htm).

5 An implication of the case law is that operating on the basis of commercial considerations is not an independent obligation under Article XVII. There are problems associated with both elements of the rules on STEs as discrimination may make economic sense and thus be consistent with acting on commercial considerations - after all, price discrimination can and often is a feature of profit maximisation strategies of private firms - while acting on a commercial basis may negatively affect the ability of STEs to achieve their mandates and thus requiring them to do may undercut the ability of governments to regulate. See e.g. Hoekman and Trachtman (2008), Matsushita and Lim (2020) and Mavroidis and Sapir (2021).

The dysfunction was evident in the heightened interest rate volatility in the bond market, reflecting the reduced liquidity even in the US Treasury market. There were wide bid/offer spreads, and bond dealer inventories were large and constrained by capital and risk considerations. As a result, the Bank bought bonds across the maturity spectrum out to ten years. Since early May 2020, as market conditions improved the RBA ceased purchases for this reason.

Following China's accession, WTO members did not use the dispute settlement mechanism to challenge alleged violations of provisions of the protocol pertaining to SOEs/SIEs – only 2 out of 22 subsidy-related cases brought against China had a SOE dimension (Mavroidis and Sapir 2021). Instead, the focus of dispute settlement turned on actions against exports of Chinese firms that allegedly received benefits (direct or indirect subsidies) from SOEs. The crux of the matter here, was whether SOEs are 'public bodies' – an issue on which China's Protocol of Accession is silent. In cases brought by China challenging the imposition of countervailing duties by the US, the Appellate Body took the view that SOEs were not necessarily public bodies.<sup>6</sup>

In contrast to the WTO, some regional integration agreements explicitly regulate the behaviour of SOEs. One important extension found in such agreements relative to the WTO is that disciplines span services as well as goods – GATT Article XVII and the ASCM only cover merchandise trade. The most far-reaching example is the EU, where the goal of creating an integrated 'single' market is pursued in part through disciplines on state aids (subsidies) and SOEs through a common competition policy. Four criteria apply for state aid to be illegal in the EU: (i) state resources (subsidies, including tax expenditure) lead to (ii) a selective advantage for a firm or activity that (iii) distorts competition and (iv) affects trade between member states. These disciplines apply to both governments and firms, including undertakings (firms) to which member states have granted special or exclusive rights, i.e. SOEs. A public services provision (Article 106 TFEU) specifies that undertakings 'entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly' are subject to the general competition rules insofar as their application does not obstruct the performance of their public tasks. Consistent with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, the EU framework focuses on identifying and removing competitive advantages of SOEs with respect to taxation, financing costs and regulation (Capobianco and Christiansen 2011). As discussed below, while the supra-national nature of enforcement of competition policy disciplines makes the EU *sui generis*, elements of the approach may inform inter-governmental cooperation under the auspices of the WTO.

6 See Ahn (2021) for an in-depth discussion. The resulting controversy became a major factor in the US decision to force the Appellate Body to cease operations by refusing to accept new appointments as sitting adjudicators reached the end of their term.

Less far-reaching economic integration agreements go beyond the ASCM by including more subsidies in the prohibited category, e.g. in specifying that state guarantees and support to insolvent or ailing companies are prohibited and banning the provision of state support on non-commercial terms to the commercial activities of SOEs (Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)).<sup>7</sup> Two-thirds of the 283 PTAs assessed by Rubini and Wang (2020) include language requiring SOEs to behave in accordance with commercial considerations and 70% of these PTAs include subsidy disciplines that apply to SOEs. Recent PTAs have more provisions and stronger disciplines on SOEs. The CPTPP, the US–Mexico–Canada Agreement (USMCA), and EU–Japan all treat SOEs as public bodies. A distinct feature of the CPTPP and USMCA – inspired by US dissatisfaction with the WTO Appellate Body rulings mentioned in footnote 5, is a focus on ownership and control in defining the coverage of disciplines. The CPTPP defines SOEs as for-profit entities with at least SDR 200 million annual turnover in which the government owns more than 50% of the shares of the SOE, has control through ownership interests of the exercise of more than 50% voting rights, or has the power to appoint the majority of the board members. SOEs are required to behave on a commercial basis and are prohibited from providing subsidised inputs or engaging in anti-competitive practices. SOEs must act in a non-discriminatory manner and governments are to put in place an impartial regulatory and institutional framework for SOEs (Licetti, Miralles, and Teh 2020).

A somewhat different approach was pursued in the 2020 China–EU Comprehensive Agreement on Investment (CAI). This does not refer to SOEs but uses a broader concept of ‘covered entities’ to define coverage. Article 3bis, Section II, requires that covered entities act according to commercial considerations, a commitment that is enforceable through dispute settlement (Dadush and Sapir 2021).

Covered entities comprise enterprises in which one of the parties to the CAI directly or indirectly owns more than 50% of the share capital; controls, through ownership interests, more than 50% of the voting rights; holds the power to appoint a majority of members of the board of directors; or holds the power to control the entity’s decisions through other ownership interest. Covered entities also encompass enterprises in which a party has the power to legally direct the actions or otherwise exercise an equivalent level of control in accordance with its laws and regulations as well as any entity, public or private, granted the right as the sole supplier or purchaser of a good or service in a relevant domestic market.

This conceptualisation reflects a combination of Chinese and EU approaches in that they do not focus on SOEs *per se* and do not equate covered entities to public bodies in the sense of the ASCM. The focus is on undertakings: agreeing on a set of entities to which agreed disciplines apply. The approach is somewhat akin to that used in the

7 Both EU PTAs and the CPTPP subsidy disciplines exclude activities of SOEs associated with providing public services in their domestic markets.

WTO Agreement on Government Procurement (GPA), which goes beyond government agencies to include commitments that pertain to utilities, railways etc. that are privately owned in some countries. Importantly, CAI Article 3bis does not prevent establishing or maintaining covered entities, and does not apply to activities conducted in the exercise of governmental authority.

Similar to GATT Article XVII, each party to the CAI commits to ensure that, when engaging in commercial activities, its covered entities will:

- Act *in accordance with commercial considerations* in their purchases or sales of goods or services in the territory of the party.
- Accord, in their purchases of goods or services, to goods or services supplied by investors of the other party and the covered enterprises *treatment no less favourable* than they accord to like goods or like services supplied by investors and enterprises of the party.
- Accord, in their sales of goods or services, to investors of the other party and to the covered enterprises *treatment no less favourable* than they accord, in like situations, to investors and enterprises of the party.

The CAI also draws on GATT Article XVII in defining ‘commercial considerations’ as the price, quality, availability, marketability, transportation, and other terms and conditions of purchase or sale, or other factors that would normally be considered in the commercial decisions of an enterprise, in the relevant business or industry, that are profit-based, and disciplined by market forces.

Article 3ter demands that each party ensures that any regulatory body or any other body exercising a regulatory function that the party establishes or maintains acts *impartially* in like circumstances with respect to all enterprises that it regulates, including the covered entities. Moreover, each Party must ensure the enforcement of laws and regulations in a *consistent and non-discriminatory manner*, including on the covered entities. This is more in the spirit of EU state-aid rules than WTO rules. EU law applies to all undertakings, independent of ownership.

Commitments concerning covered entities are enforceable. In case a party considers that a measure by the other party violates the CAI’s commitments, it can request arbitration. If the panel rules in favour of the complainant, and the respondent fails to abide by the decision of the panel within a reasonable period of time, the complaining party may retaliate by adopting a measure that has an equivalent effect.



### 3. MOVING FORWARD

The key to resolving problems related to SOEs is to introduce disciplines to ensure that they act in accordance with commercial considerations. Two possible approaches can be envisaged to do so in the WTO context. One option is to agree on a new ASCM understanding, which equates SOEs with public bodies, with findings of subsidy if SOEs do not act in accordance with commercial considerations. This option is elaborated in Mavroidis and Sapir (2021). Another option is to negotiate a new understanding on SOEs that revisits GATT Article XVII by broadening its coverage beyond STEs and extends disciplines to entities that operate in services sectors. This could build on the approach followed in the CAI and focus on defining a category of ‘covered entities’, and clarifying the distinction (relationship) between non-discrimination and operating in accordance with commercial consideration.<sup>8</sup>

Any deal on SOEs would require participation of the US, the EU, and the People’s Republic of China. Framing the rationale for stronger disciplines on SOEs as a need to ‘reform’ China is doomed to fail. Conversely, China must accept that it has to play a central role in the development of a new regime for SOEs. All three players should accept that (i) their political economies are consistent with market-based competition, and (ii) will remain profoundly different from one another. As noted by Sabine Weyand, EU Director-General for Trade at an event celebrating the 25th anniversary of the WTO: ‘...the WTO is not the place to drive systems change. It is not about regime change. This is about dealing with the consequences of certain economic systems and to make sure that these are being dealt with in a manner that everyone can live with. And that requires compromise on all sides’ (Monicken 2020).

A first step should be to collect and analyse information on the operation and impacts of SOEs. As is the case for subsidies (Hoekman and Nelson, 2020), there is much sound and fury around Chinese SOEs, but too little focus on the activities of SOEs. While it is relatively straightforward to compile information on the prevalence of SOEs, a more serious challenge is to compile data on SOE operations and their effects on market competition. Governments do not know enough about the cross-border competitive spillover effects of SOEs. Only one-third of PTAs that include SOE provisions have notification requirements, and only 10 out of 283 foresee collaboration in generating information on the operations of SOEs (Rubini and Wang 2020). In practice, therefore, PTAs appear to do relatively little to address the need for up-to-date information on SOEs, which in turn is necessary to assess cross-border spillover effects, and more importantly from a domestic policy perspective, evaluation of the effects of these types of instruments.

8 See, e.g. Ding (2020) and Qin (2004) for arguments in favor of a broader approach akin to that included in the CAI.

This is something that can be addressed in the WTO. In the Uruguay Round, it was agreed to bolster disciplines on – and surveillance of – STEs. The Council for Trade in Goods established a Working Party on STEs in February 1995. Governments were required to notify all STEs for review by the Working Party, apart from imports intended for consumption by government bodies or STEs themselves. Notifications must be made, independent of whether imports or exports have in fact taken place, and WTO members may make counter-notifications. The Working Party reports annually to the Council for Trade in Goods. The Working Party developed a questionnaire on state trading, based on a draft Illustrative List of State Trading Relationships and Activities that was adopted in 1999. A total of 58 WTO members notified the existence of STEs as of 1995. In 2006, the Working Party reviewed a total of 17 notifications, some of which date back to 2002. Some 75% of STEs notified to WTO operate in the agricultural sector (Hoekman and Kostecki 2009).

A similar effort is needed to prepare the ground for agreement on new rules that are mutually beneficial to all parties. This is useful not just to determine the extent of the problem, magnitude, and incidence of possible negative competitive international spillovers. As important, is the role that greater transparency (better data) can play as an input into analysis of performance of SOEs, their implications for public sector debt, government budgets, financial stability, and understanding whether social goals are being realised efficiently (see, e.g. Musacchio and Pineda Ayerbe 2019, IMF 2020, Wolfe 2017). As noted previously, the limited extant evidence suggests SOEs often have much lower productivity than other firms operating in the same sector.

Such work will need an institutional anchor. The WTO is the obvious candidate. Even though it may seem unlikely that the membership will be willing to give the secretariat a mandate to take on the type of analytical role played by the OECD secretariat, the WTO can, and should, provide a platform for a concerted effort to improve the information base. This could take the form of a Working Party or a ‘Joint Statement Initiative’ along the lines of those launched in 2017 at MC11.

Would such an exercise be possible? We believe it will be challenging but recent engagements spanning all three major powers (and many other countries) suggest it may be feasible. An illustration is the Global Forum on Steel Excess Capacity (GFSEC), with ministerial meetings taking place once a year since November 2017. This focuses on one sector, steel, where subsidies are held to be a major factor distorting international competition. It aims at improving the extant information base on supply conditions and investment, drawing on the expertise at the OECD on the sector. A weakness of the GFSEC is that it does not seek to establish a comprehensive baseline dataset spanning all steel-related policy support provided by different levels of governments in a country. A consequence is an inability to assess the effects of policies. In the SOE context such analysis is important to clarify to what extent SOEs act in accordance with commercial considerations and evaluate the magnitude and incidence of cross-border effects on competition.

#### 4. CONCLUDING REMARKS

Many OECD member governments have made it clear that they consider large, for-profit SOEs to constitute a problem for the trading system. They have also argued that one element of a solution is to agree that SOEs should be considered as a ‘public body’ for purposes of the application of WTO rules (the ASCM). Most prominent has been the ‘trilateral’ group – the EU, Japan, and the US – which has held a series of meetings starting in 2018 to identify ways to strengthen disciplines on subsidies and SOEs. One result has been the suggestion to expand the list of prohibited subsidies in the WTO to include SOEs and preferential pricing for inputs.<sup>9</sup> Recent PTAs provide valuable information on the types of disciplines that may be considered in augmenting extant WTO rules. Expanding the coverage of such rules to China is important for the continued salience of – and support for – the trading system, given that SOEs have become a major source of trade tensions. However, reliance on PTA-based disciplines is clearly insufficient and may even be counterproductive insofar as they give a competitive advantage to SOEs based in jurisdictions that are not members of the respective PTAs (Lefebvre et al. 2021).

Drafting exercises to clarify and extend the ASCM that build on disciplines negotiated among signatories of the CPTPP, USMCA, EU-Japan etc. appear to be a pragmatic response to changed circumstances. Doing so has the advantage of probably being more feasible in a multilateral WTO context than revisiting and extending the current rules on STEs. But the China-EU CAI illustrates that there is an alternative option, one that goes beyond a focus limited to state-ownership and viewing matters through the lens of subsidies to and by SOEs. A non-negligible consideration here is that the CAI approach has been agreed by two of the big three WTO trade powers, whereas the CPTPP and USMCA were developed and agreed by signatories without participation by China, reflecting the desire to define the rules of the game for China. The associated political baggage may reduce the prospects that China will engage in a process that starts from the premise that the CPTPP provides a good template for deliberation in the WTO setting. This bolsters the case for exploring the possibility of using elements of the CAI as a basis for plurilateral engagement on SOEs. On the other hand, while perhaps more politically feasible, a WTO agreement based on the CAI would probably provide less discipline on SOEs than if it were based on the CPTPP and USMCA.

Whatever approach is pursued, WTO members currently do not have sufficient information to develop a common understanding of where new rules may be needed, as opposed to tweaking existing WTO provisions on STEs and subsidies. A first step could be for the EU and China – probably the two main jurisdictions where SOEs are headquartered – to take the lead on creating a WTO Working Party on SOEs to prepare the ground for a negotiation on new rules for SOEs. Such a negotiation should be

<sup>9</sup> See, e.g. Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the EU, 9 January 2019. At: <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/january/joint-statement-trilateral-meeting> and [https://trade.ec.europa.eu/doclib/docs/2020/january/tradoc\\_158567.pdf](https://trade.ec.europa.eu/doclib/docs/2020/january/tradoc_158567.pdf).

conceptualised as a plurilateral effort along the lines of the ‘joint statement initiatives’ launched in 2017 at the 11th WTO Ministerial Conference. Agreement among all 164 WTO members is not necessary, as most WTO members’ SOEs do not create systemic spillovers. What is necessary is that the three major players – China, the EU, and the US – cooperate with the aim of promoting a solution within the multilateral WTO legal order.

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