Checkers Or Chess? Facing State Capitalism — Part II

Law360, New York (April 22, 2011) -- So how should the international community respond to the concerns about state capitalism outlined in Part I of this article? How do you level the playing field in the long term against state capitalism? Responses to state capitalism require us to think more like chess players.

In the case of sovereign wealth funds, the policy response came in the form of the Santiago Principles. Developed by a working group in close association with the Organisation for Economic Co-operation and Development (OECD) and leading sovereign wealth funds, the Santiago Principles set out generally agreed-upon principles and practices in support of greater transparency and a passive approach to investment.

Key among these principles are 1) investments are to be made on the basis of economic and financial risk and return-related considerations; and 2) transparent and sound governance structures are needed to provide adequate operational controls, risk management and accountability.

While the principles have yet to be fully put to the test, given the financial crisis, they do represent a real policy response to ensure that state-backed investments abroad were done on a commercial basis, in line with the principles of market-based economies.

But the challenges presented by state capitalism are wider and deeper than what the Santiago Principles aimed to address. For one thing, they don’t address the barriers to and protection of inbound private investment into state capitalist economies.

They also do not address trade in goods or services in either direction, state-directed commercial procurement, government procurement, or even basic competition conditions in a market where state enterprises and private actors coexist. And they do not require transparency or market-based terms in connection with the funding of state enterprises or funds.
These policy areas remain frontiers that need further exploration and answers. However, discussions are taking place in various circles, offering potential solutions ranging from the establishment of norms and rules in free trade agreements and new plurilateral approaches to discipline anti-competitive actions of state-owned enterprises putting in place domestic mechanisms to safeguard against anti-competitive trading and investment activities (e.g., European state aids controls).

Indeed, when taking an inventory of the current international norms and rules that might be used to discipline state capitalism, one notices immediately that these are insufficient.

In the World Trade Organization General Agreement on Tariffs and Trade (GATT), for instance, there is an attempt to ensure that the global economy would be a place where all actors private or state would base decisions on economic principles and market circumstances, rather than government directives.

To that end, the GATT requires state enterprises, in relation to their purchases and sales involving either imports or exports, to operate in a manner “solely in accordance with commercial considerations.”

It should be noted, however, that this language is a watered-down version of the original proposed text. In addition, this discipline has been further emasculated in WTO disputes, such as the Canada Wheat Board case, where the panel interpreted this language as allowing state enterprises to continue to use any and all special privileges granted to them by their governments.

Outside of the WTO rules, attempts to discipline state capitalism have arguably increased in the context of U.S. free trade agreements (e.g., NAFTA, the U.S.-Singapore and the hopefully soon-to-be ratified Korea-U.S. Free Trade Agreement), they remain woefully inadequate to address the challenge.

Non-U.S. trade agreements, such as those between Canada and Chile and between Canada and Jordan, are also very limited in their approaches. The recently negotiated EU-Korea agreement, though, shows more promise. As for bilateral investment treaties, the concern of state capitalism has been largely ignored.

In light of the current state of these disciplines, one policy approach may be to amend and bolster these existing narrow provisions to give them more teeth. Or certain other provisions in trade agreements, such as the “national treatment” provision, could be expanded to cover suppliers of goods or services, in order to require that governments ensure their state-owned and state-assisted enterprises act like any other private entity, i.e., in a commercial manner.

Alternatively, new language — such as that requiring a state enterprise to act “in accordance with its own commercial interests” or “in a competitively neutral manner” — which would be unburdened by unfortunate jurisprudence (as noted in the aforementioned WTO decision), could be added into future agreements, such as the Trans-Pacific Partnership (TPP) agreement and new bilateral investment treaties.

Such new terms may need time to gain international acceptance, but if interested governments are willing to engage in extended efforts to infuse the new disciplines into as many trade-related initiatives as possible, state capitalism may eventually be curtailed sufficiently to allow for a level playing field between private and state actors.
Whether or not new rules are built from existing ones, a key issue will be to provide sufficient specificity to ensure that whatever provisions are adopted, they will have meaningful effects.

For example, an agreement calling for state enterprises to act on “commercial terms” may be a starting point, but that concept leaves quite a bit of room for interpretation and possible circumvention. Ideally, a future agreement would effectively codify various activities that fall inside or outside the ambit of such a key concept.

If negotiators cannot reach common ground on these kinds of important details, an alternative path forward might be to develop an “illustrative list” of approved or disapproved practices. This course was followed in the WTO agreements regarding prohibited export subsidies, among other illustrative lists. Surely such lists could always be more detailed and precise, but at least they provide concrete guideposts for nations to follow.

Another approach may be to incorporate additional concepts from the competition policy area. For instance, governments can empower domestic antitrust authorities and create new obligations under their competition policy to restrain state enterprises from engaging in anti-competitive conduct such as setting prices, restricting output and other exclusionary activity.

State enterprises should also be made subject to the most basic antitrust scrutiny, such as merger review. In fact, this approach would be in line with work done in the OECD and the International Competition Network (ICN). Both have discussed state capitalism concerns from an antitrust angle to varying degrees, and ideas from these discussions might be worth considering going forward.

For instance, these organizations have noted that in order to ensure a truly commercial environment, national authorities should seek to treat state monopolies like private entities, and to amend the domestic legal and regulatory framework governing state enterprises to ensure a level playing field in all markets where the state actor and the private sector compete, so as to avoid market distortion. Care must be taken, however, to ensure that antitrust laws are not abused to protect state capitalism.

Other ideas to discipline state capitalism abound. One involves negotiating a new state capitalism plurilateral agreement, perhaps under the WTO or OECD umbrella. Such an agreement would be voluntary in nature, allowing governments to choose to join or not.

However, the obvious limitation is that countries with the most state enterprises or that engage most often in industrial policies are likely to be the ones that do not sign on to such an agreement. Nevertheless, to have comprehensive disciplines housed in one agreement, even with limited signatories, may be a giant step in the right direction, particularly for purposes of building consensus and momentum within the international community.

Another idea that has been floated is developing new investment screening mechanisms that would review a state’s involvement in supporting foreign investment through financial or regulatory preferences. Some have suggested, for example, that the U.S. adopt a methodology for reviewing foreign investment similar to that employed by the U.S. Commerce Department to screen for unfairly subsidized exports from nonmarket economies.
While inherently protectionist in nature, this approach could serve as a stopgap tool for countries seeking to ensure competitiveness prior to the establishment of final international disciplines. In fact, an active discussion is under way in Europe regarding the creation of an investment screen that would rely on state-aid controls to review inbound investments. Such a tool could also be used to scrutinize the level of openness to FDI of the investor’s country to ensure reciprocal market access.

Finally, also worthy of consideration is an expansion of general transparency obligations that are found in every international trade and investment agreement, to explicitly require increased transparency whenever a state intervenes in the commercial marketplace.

Indeed, some have argued that having access to information about a state enterprise’s ownership structure, decision-making process, specific government rules and benefits accruing to it will by itself go a long way toward leveling the playing field.

**A Balanced Solution**

In response to the financial crisis, the U.S. government took unprecedented steps to enter the economy by capitalizing banks and taking outright ownership over giants from within the banking, insurance and manufacturing sectors. In addition, long-time government-sponsored entities like Freddie and Fannie received even greater assurances.

As we look to develop policy responses to the rise of state capitalism, we must clearly delineate responsive actions taken by governments in times of crisis to prevent economic collapse from those actions designed to ensure the profitability, expansion and economic dominance of certain state-owned or state-assisted players in markets at home and abroad.

In fact, since the financial crisis, we have seen an actively receding hand of government ownership and influence here in the U.S., as much of the capital has been repaid and plans are in place for the continued repayment.

The U.S. government, therefore, should not feel limited based on its defensive concerns from actively formulating aggressive international economic trade and investment policies to address anti-competitive aspects of state capitalism.

Any government in times of unquestionable crisis should retain the ability to for a limited time only enter its market to re-establish stability. During the financial crisis, the U.S. response was not only prudent, but it was thoughtful and cognizant of the potential challenge of government intervention in the market.

Still, it could also be argued, other conditions — such as executive compensation rules or requirements to build smaller, more energy-efficient cars — that were imposed could have decreased the ability of private companies to compete in the market.

In the end, policy solutions must be developed to strike the right balance between competition and stability. The state will continue to have an important role in the economy, including through ownership of select entities that provide public goods and services that the market is unable or unwilling to provide.
Though, in the 21st century, in order for trade and investment to continue to be key drivers in global economic growth and consumer welfare, the terms of competition between the state and private commercial actors must be more meaningfully defined.

Without a political articulation and subsequent commitment to implement the concept of “competitive neutrality,” the global trading system, which has historically thrived on a shared commitment to market liberalization and free competition, will be undermined.

The stakes are enormous and growing rapidly, particularly as foreign direct investment from emerging economies into the developed world accelerates. Therefore, solutions are urgently needed to safeguard the global economic system against market-distorting practices of governments that bestow financial and regulatory benefits on national champions with the aim of unfairly capturing a commanding height in the global marketplace. These solutions will need to be as strategic as state capitalism is itself. Chess anyone?

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