THE IMPORTANCE OF COMPETITIVE NEUTRALITY IN PROMOTING FDI AND SUSTAINABLE RECOVERY

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The Importance of Competitive Neutrality in Promoting FDI and Sustainable Recovery

By Sophie Flaherty

Competitive neutrality principles encourage FDI by promoting a level playing field among competitors. When certain market players, such as SOEs, or selected private firms, are granted unfair advantages or are subject to different rules, the domestic and international competitive landscape may be distorted. As FDI is essential in ensuring sustainable recovery from the current crisis, governments should pursue measures that ensure effective competition in their home economies and that encourage the implementation of international competitive neutrality standards. This article will focus on the importance of competitive neutrality in encouraging FDI. It will discuss how competition law and policy can help address these concerns and will highlight the importance of international cooperation.

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I. INTRODUCTION

The COVID-19 crisis has increased concerns over the risks of inward foreign investment. Before the pandemic, governments were already showing signs of increased caution, with foreign direct investment ("FDI") screening mechanisms gaining momentum. The current health and economic crisis has fast-tracked this trend. Unlike the 2008 economic crisis where many countries became more open to foreign investment, the COVID-19 crisis has instead encouraged greater economic protectionism and with this, the adoption and reform of investment screens.[2] Host countries are more and more concerned about foreign acquisition of critical infrastructure and strategic technology, and screening mechanisms can be used to block such FDI on, for example, national security and public order grounds.[3]

The OECD Investment Division has explained that one of the reasons for the different approach could be the increased role of State-Owned Enterprises ("SOEs") as foreign investors.[4] Indeed, "the share of OECD countries that single out state-owned acquirers in the context of FDI screening has grown from eight to fourteen since the beginning of 2020."[5] As previously explained by the OECD, FDI concerns are "exacerbated by the unique characteristics of SOEs" including "their proximity to the sovereign powers of individual nations."[6] Screening mechanisms tend to concentrate on their potential "pursuit of non-commercial objectives,"[7] but in addition, FDI by SOEs may raise competitive neutrality concerns. Failure to adhere to competitive neutrality principles can distort the domestic and international competitive landscape and affect FDI.

As FDI is essential in ensuring sustainable recovery from the current crisis, governments should pursue measures that ensure effective competition in their home economies and that encourage the implementation of international competitive neutrality standards. This article will therefore focus on the importance of competitive neutrality in encouraging FDI and will discuss how competition law and policy can address these concerns.

II. THE IMPORTANCE OF COMPETITIVE NEUTRALITY FOR FDI

Competitive neutrality principles aim to promote a level playing field among competitors by requiring firms to be subject to the same set of rules irrespective of factors such as their ownership or nationality.[8] Competition may be distorted when certain market players, such as SOEs,[9] or selected private firms,[10] are granted unfair advantages or are subject to different rules. This can affect FDI into the domestic market and raise concerns for host countries when such firms expand abroad.

States can give preferential access to markets to some firms (SOEs or domestic firms, for example) by imposing entry restrictions. Leaving aside foreign equity limitations, states can distort market access creating a statutory monopoly, imposing licensing restrictions or technical and capital requirements on some market players or by implementing qualification rules in public procurement that treat market players differently. States can also enhance the performance of certain firms by providing cost or revenue advantages, for example, subsidies, favorable loan rates

2 See OECD, *Investment screening in times of COVID – and beyond*, June 23, 2020.

3 See for example, Regulation (EU) 2019/452 of the European Parliament and of the Council of March 19, 2019 establishing a framework for the screening of foreign direct investments into the Union. The German *IMST/Addsino* merger prohibition is a recent example where state ownership was key to security concerns.

4 OECD, *Investment screening in times of COVID – and beyond*, June 23, 2020, page 6.

5 OECD, *Investment screening in times of COVID – and beyond*, June 23, 2020, page 6.

6 OECD, Sta*te owned enterprises as global competitors: a challenge or an opportunity*? 2016, p.150.

7 OECD, St*ate owned enterprises as global competitors: a challenge or an opportunity*? 2016, p.150.

8 See OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021].

9 See the work by both the Competition Committee and the Corporate Governance Committee's Working Party on State-Ownership and Privatisation Practices. A State owned enterprise is defined in the OECD SOE Guidelines and the OECD Recommendation on Competitive Neutrality as "any corporate entity recognised by national law as an enterprise, and in which the state exercises ownership or control, should be considered as an SOE. This includes joint stock companies, limited liability companies and partnerships limited by shares. Moreover statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities, or parts of their activities, are of a largely economic nature."

10 For example, foreign firms with close government ties. See e.g. Government of Canada, *Policy Statement on Foreign Investment Review and COVID-19*, April 18, 2020, https://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk81224.html. China's Digital Silk Road initiative, for example, is said to be largely driven by private firms but heavily supported by government policies. See, for example, SupChina, Paul Triolo and Robert Greene, *Will China control the global internet via its Digital Silk Road?* May 8, 2020, https://supchina.com/2020/05/08/will-china-control-the-global-internet-via-its-digital-silk-road/

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and government guarantees. Finally, states can make it easier for specific firms to operate in a market by granting exemptions from the regulatory framework or by applying more favorable rules to certain firms.

The political rationale for different treatment of certain firms varies. The role of SOEs in the economy, for example, differs worldwide. In some countries, SOEs are primarily used to address specific market failures while in other countries SOEs are key to carrying out a wide range of policy objectives. The justification for special treatment may be to compensate the SOE for its public policy obligations and special duties. However, if these advantages extend to or are used to cross-subsidize the provision of goods or services in markets where SOEs compete or could potentially compete with private firms, the SOE will have an unfair advantage in the market.[11]

This can distort the competitive landscape, both in the country where the advantage is given and in foreign markets, where the SOE is active. First, such advantages may prevent or make it more difficult for both domestic and foreign firms to enter the local market and to compete with the SOEs. This may limit the number or range of suppliers in the market and reduce FDI. Second, it may give SOEs competing abroad unfair advantages in foreign markets, reducing competition in those markets. Such advantages can also decrease allocative efficiency, supporting inefficient firms that may have exited the market if subject to normal competitive conditions. Less competition in the market may result in reduced consumer welfare, with less innovation, lower quality goods and services and higher prices.

While SOEs are often the most obvious example, private firms may also enjoy special treatment, for example, as former SOEs, firms with close government ties or as "strategic" firms. It is therefore important to implement best practices to ensure competitive neutrality in competitive markets, both between SOEs and private firms and between different private firms.[12] Adherence to such principles encourages a level playing field and thus FDI. This does not mean that selected firms cannot be supported, but when doing so states should ensure the least harmful approach and should seek to uphold competitive neutrality principles.[13] States should, for example, "limit compensation for any public service obligation" ensuring "that it is appropriate and proportionate to the value of the services." In doing so, states should clearly define public service obligations, separate regulatory and commercial functions and ensure transparency and accountability. In relation to SOEs, states should adopt best practices for corporate governance and structural separation.[14]

III. EXAMPLES OF THE USE OF COMPETITION LAW AND POLICY TO ADDRESS THESE CONCERNS

A. EU State Aid Regime

The EU has a state aid regime that prevents Member States granting subsidies that may distort the EU single market.[15] Foreign subsidies are not subject to EU State Aid rules. However, research has suggested that if certain foreign subsidies had been granted by Member States, they would have amounted to state aid and so "this difference in treatment can distort competition in the EU's internal market" and "makes it difficult to achieve a level playing field" with the relevant non-EU countries.[16] Following an EU *white paper on levelling the playing field as regards foreign subsidies*,[17] on May 5, 2021, the EU published a proposal for a regulation *on foreign subsidies distorting the internal market*.[18]

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11 The opposite can also occur, if the SOE is not adequately compensated for its public service obligations and special duties.

12 See for example OECD, *Competitive Neutrality – A compendium of OECD recommendations, Guidelines and Best practices*, https://www.oecd.org/daf/ca/50250955.pdf and OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021].

13 See OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021]. It recognizes "that achieving public policy objectives will in certain circumstances require exceptions to competitive neutrality." It considers that "other things being equal, public policies with lesser harm to competition should be preferred over those with greater harm to competition, provided they achieve the identified objectives."

14 OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021], Part II(2)(a-c).

15 See Articles 107 and 108 of the TFEU.

16 European Court of Auditors, 2020, *The EU's response to China's state-driven investment strategy*, pp. 15 and 47, https://www.eca.europa.eu/Lists/ECADocuments/RW20_03/RW_EU_response_to_China_EN.pdf.

17 The *White paper on levelling the playing field as regards foreign subsidies* was adopted on June 17, 2020. https://ec.europa.eu/competition/international/overview/foreign_subsidies_white_paper.pdf.

18 Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market, https://ec.europa.eu/competition/international/overview/proposal_for_regulation.pdf.

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The proposed regulation aims to ensure a level playing field by identifying and remedying market distortions caused by foreign subsidies and seeks to complement the FDI screening regulation.[19] The regime would be enforced by the EU Commission and would cover subsidies granted by non- EU countries, irrespective of ownership (SOEs and private firms) and sector coverage. If implemented in its current form, it would allow, among other things, *ex ante* review of distortive foreign subsidies (over €50 million) in the case of concentrations above a certain threshold (notifiable transactions) or at the request of the Commission (Chapter 3). This would run in parallel with, but be separate to, any merger review process. The proposal also provides for *ex officio* review powers (Chapter 2) and addresses distortions that may arise in public procurement (Chapter 4).

B. Merger Review

In most jurisdictions, merger review may address competitive neutrality issues indirectly. Where a competition authority is able to consider "public interest" arguments or undertakes a concurrent review under other standards, a merger involving an SOE may be more closely scrutinized yet conflicts may arise between competition and other policy goals.[20] Most governments keep FDI screening mechanisms separate from merger review. The EU Regulation 2019/0452 *establishing a framework for the screening of foreign direct investments into the Union* was created to avoid politicizing merger control and the consideration of non-competition concerns in the merger review process. However, Member States apply their own screening mechanisms and while most have concurrent but separate processes, Poland, for example, has conferred FDI review powers on its national competition authority.[21] As mentioned above, the EU Commission will apply the proposed foreign subsidy regulation in order to ensure uniformity in its implementation and in considering "the role of Member States in competition and State aid instruments."[22]

C. Enforcement Action

Many of the advantages described in this article do not necessarily result in any anti-competitive conduct and so may not be possible to address through enforcement action.[23] Enforcement action can address competitive neutrality concerns indirectly by addressing anti-competitive behavior of SOEs or privileged private firms (for example, predatory pricing by dominant firms). It is therefore important that competition law is competitively neutral.[24] In some jurisdictions, issues may arise if there are statutory exemptions for SOEs in the competition law or there are political or practical challenges (for example, in relation to evidence) in taking action against SOEs.[25]

D. Advocacy

Before seeking to target the behavior of foreign SOEs, countries should ensure the enforcement of competitive neutrality in their own markets. Few countries have a comprehensive competitive neutrality framework, but some countries give their competition authorities or other nominated bodies enforcement powers in relation to competitive neutrality.[26] Competition authorities can also use market studies or investigations to identify distortionary measures in a particular market. More generally, as part of their advocacy functions, competition authorities (or other bodies) can

19 Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market, pp. 5,7, 48. https://ec.europa.eu/competition/international/overview/proposal_for_regulation.pdf.

20 OECD, *State owned enterprises as global competitors: a challenge or an opportunity*? 2016, pp.114-115.

21 See Svetlicinii, A, National Competition authorities and FDI screening: the case of Poland, October 8, 2020, http://competitionlawblog.kluwercompetitionlaw.com/2020/10/08/national-competition-authorities-and-fdi-screening-the-case-of-poland/.

22 Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market, pp. 21-22, https://ec.europa.eu/competition/international/overview/proposal_for_regulation.pdf.

23 The Swedish competition laws however provide an example where competitive neutrality could be enforced through the competition law, which prohibits SOE conduct that distorts the competitive process. See, OECD, Roundtable on competitive neutrality in competition enforcement, note by Sweden, May 29, 2015.

24 See OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021], Part II (1)(a), which requires adherents to "adopt or maintain, as appropriate, a competitively neutral competition law that addresses anti-competitive conduct and includes merger control."

25 See OECD, *State owned enterprises as global competitors: a challenge or an opportunity?* 2016, p.115. Indonesia, for example, has discretion to exempt SOEs from its competition law. Some countries have trade agreements that include transparency and information provisions in relation to SOEs. For example, the competition chapters of the 2009 Australia-Chile FTA and the 2005 Australia-US FTA contain such provisions (Source: OECD Database on National Practices and Regulations with Respect to State Enterprises, https://qdd.oecd.org/Home/ApplyFilter).

26 OECD, *State owned enterprises as global competitors: a challenge or an opportunity?* 2016, p. 113.

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conduct competition assessments[27] or competitive neutrality reviews,[28] of proposed and existing laws and regulations to identify provisions that restrict market access or impose discriminatory requirements.[29]

Authorities can analyze, for example, how SOEs are treated within a specific sector and whether they are given any specific advantages or excluded from regulatory requirements that contribute to an uneven playing field in the domestic market. In carrying out this assessment, they can consider the harm to competition and propose alternative policies in line with the underlying policy objective. This exercise can help inform policymakers of necessary reforms and prevent the introduction of laws and regulations that may be harmful to competition and investment.

IV. THE NECESSITY OF INTERNATIONAL STANDARDS

In order to prevent special rights and privileges granted to certain firms in one market distorting the competitive environment in a host country market, international cooperation is key. There are a few international instruments, for example, through the WTO, which target discriminatory behavior of governments and that can address certain aspects of competitive neutrality. There is however no comprehensive multilateral framework.[30]

Regional mechanisms address aspects of competitive neutrality, such as the EU state aid regime, which addresses distortive subsidies at the EU level and has inspired the new EU proposal addressing foreign subsidies and provisions in certain EU trade agreements. Competitive neutrality principles, notably those targeting distortive behavior of SOEs, may appear in some preferential trade agreements and bilateral investment treaties.[31] However, as noted by the OECD, "considering the very broad set of issues at stake it must be recognized that competitive neutrality is difficult to maintain in the international marketplace unless the participating countries engage in a concurrent commitment to enforcing it at home."[32] International rules and standards on competitive neutrality should therefore be pursued.

Harmonization is key and in itself can contribute to increased trade and investment. The OECD has already published several recommendations that relate to competitive neutrality, notably concerning corporate governance of SOEs.[33] In addition, on May 31, 2021, the OECD adopted a recommendation on competitive neutrality.[34] This recommendation hopes to fill the gap in international standards. However, as previously noted by the OECD, adherence of non-members to such standards is vital. In relation to SOEs active in foreign markets, for example, most are owned by non-OECD member countries,[35] and so broad implementation will be key to minimizing distortions caused by FDI and to promoting a level playing field.

27 The OECD *Competition Assessment Toolkit* can help identify different kinds of barriers to FDI. See also, Recommendation of the Council on Regulatory Policy and Governance [OECD/LEGAL/0390]. See, OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021], Part II (1)(c)(iii). The Recommendation of the Council on Competition Assessment [OECD/LEGAL/0455] recommends that adherents should "Carry out competition assessments that identify and revise existing or proposed regulations that unduly restrict competition."

28 See, for example, the OECD Competitive Neutrality Reviews, Towards a Level Playing Field between SOEs and Private Entities in ASEAN, https://www.oecd.org/daf/competition/towards-a-level-playing-field-logistics-sector-asean.htm.

29 In relation to barriers in public procurement, see Recommendation of the Council on Public Procurement [OECD/LEGAL/0411].

30 For example, some WTO instruments address subsidies for trade in goods. See, the SCM Agreement and the GATT. See also, the GATS. There have been several WTO cases, for example, relating to preferential treatment of SOEs. See, Kowalski, P & Perepechay, K, *International Trade and Investment by State Enterprises*, 2015, pp.27-29.

31 For example, Chapter 17 of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

32 OECD, *State owned enterprises as global competitors: a challenge or an opportunity*? 2016, p.126.

33 For example, OECD, Recommendation of the Council on Guidelines on Corporate Governance of State-Owned Enterprises [OECD/LEGAL/0414](OECD Guidelines on Corporate Governance of SOEs), OECD, Recommendation of the Council concerning Structural Separation in Regulated Industries [OECD/LEGAL/0310].

34 OECD, Recommendation of the Council on Competitive Neutrality [OECD/LEGAL/2021].

35 OECD, *State owned enterprises as global competitors: a challenge or an opportunity*? 2016, p. 155.

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V. CONCLUSION

In order to uphold competitive neutrality principles and to avoid distorting the competitive process, regulatory frameworks should be neutral, and states should not grant discriminatory advantages to SOEs or selected private firms. Failure to adhere to competitive neutrality principles can affect FDI and distort the domestic and international competitive landscape. Governments should thus ensure competitive neutrality in their home markets and advocate for international implementation of competitive neutrality principles to encourage FDI, an important driver of sustainable recovery.

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