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## Host governments should not treat state-owned enterprises differently than other foreign investors

by

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The growth of outward foreign direct investment (OFDI), particularly from China, has generated substantial controversy about whether government-controlled or state-influenced foreign investors should be treated differently than other foreign investors by host country governments. [1] Indeed, several developed country governments impose special review procedures on OFDI undertaken by state-owned enterprises (SOEs). For example, in 2012 the Canadian government announced that takeovers of domestic companies by foreign SOEs would face “strengthened scrutiny,” permitting them only in “exceptional circumstances.”[2]

The fundamental concern about SOEs is that their business activities will harm the host economy because they are dictated primarily by political, rather than commercial, objectives. The degree to which this is presently true is debatable. Moreover, the policy implications of this assessment, however valid, are rarely rigorously articulated and evaluated. Rather, it is assumed that the pursuit of non-commercial objectives by foreign investors harms the host economy and, therefore, should be discouraged or prevented entirely.

If there is a theme linking the impact of OFDI by SOEs to the welfare of the host economy, it is that the pursuit of non-commercial objectives will result in inefficient behavior and performance on the part of SOEs, which in turn will weaken the host economy. However, to the extent that SOEs willfully engage in inefficient economic behavior, the harm will be experienced primarily by the SOEs’ owners, and not by residents of the host economy. This argument rests on the notion that the foreign investor ordinarily pays a price for foreign assets acquired (usually an operating company) that reflects the discounted present value of the assets when owned and managed by an investor whose objective is to maximize profits by operating the acquired assets efficiently. Put simply, in a competitive market for corporate assets, SOEs will need to bid prices that reflect the efficient or profit-maximizing use of the assets to be acquired, even if the SOEs intend to engage in certain non-efficient behaviors. The result is that existing domestic owners should be no worse off financially by selling to an SOE than they would be by selling to a privately owned foreign investor. Indeed, they should be at least marginally better off, given that the winning acquirer presumably pays a higher price than unsuccessful bidders.

So who in the host economy is made worse off by SOE investments? One argument is that multinational enterprises (MNEs) from emerging markets behave less responsibly than their for-profit counterparts headquartered in developed countries in areas like environmental and labor practices. SOEs are also seen as being much less transparent in their financial and social impact reporting than privately owned MNEs. These issues highlight the concern that SOEs from emerging markets are likely to impose costly externalities on host economies.

Yet, regulators, particularly those in developed countries, can restrain SOE behavior, thereby reducing negative externalities.[3] Even if Chinese and other SOEs are imperfectly informed about the regulatory environment when entering a host economy, substantial fines and regulatory censure should quickly educate SOE management about legal and illegal business practices. To be sure, not all objectionable business practices by SOEs are regulated, or even detected, by regulators; however, other market participants can also act as a check on opportunistic behavior by SOEs. For example, prospective employees should demand higher wages from SOEs than from private companies if SOEs implement unfair labor practices. Similarly, consumers should demand lower prices from SOEs than from private companies if the former are perceived as being less safety conscious. In short, corporate misbehavior by SOEs could be substantially internalized by those SOEs in the form of lower profits.

Finally, while many governments provide direct or indirect support for OFDI to their MNEs investing abroad, the support provided by the Chinese government has been criticized for giving Chinese SOEs an unfair advantage in acquiring foreign assets or for driving out efficient domestic firms.[4] Related to an earlier point, competitive bidding for foreign assets may result in much of the Chinese government subsidies being captured by shareholders of acquired companies in host economies. Furthermore, if the acquired assets are managed inefficiently, foreign affiliates of SOEs may require ongoing financial subsidies in order to survive in the marketplace against more efficient rivals. Even the Chinese government faces financial limits to its ability to support its home country MNEs. The termination or reduction of government subsidies would invite the re-entry of efficient host-country firms.

One should not conclude from this discussion that OFDI by SOEs does not raise any public policy issues. For example, specific investments may raise concerns about national security. However, national security concerns may also arise from OFDI by European or United States (US) MNEs, as demonstrated by recent revelations about U.S. electronic espionage in Europe. The main point is that host country governments should reassess their hostility toward investments by SOEs or risk losing access to an important source of investment capital.

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[1] Most OFDI from China is undertaken by SOEs. *See* Ken Davies, *China Investment Policy* (Paris: OECD, 2013).

[2] Wendy Dobson, "China's state-owned enterprises and Canada's FDI policy" (Calgary: University of Calgary, 2014).
[3] *Id.*
[4] UNCTAD (2006), "Developing Countries are Beginning to Promote Outward FDI", http://unctad.org/en/Docs?webiteiia20065_en.pdf.

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