2011 Global Services Summit: Engaging the Dynamic Asian Economies

Washington, DC

July 20, 2011

"21st Century" Trade Issues:

The challenges to services trade and investment from state-owned/assisted enterprises, restrictions on data flows, and forced localization

Coalition of Services Industries & U.S. Chamber of Commerce's Global Regulatory Cooperation Project

STATE-OWNED ENTERPRISES: CORRECTING A 21st CENTURY MARKET DISTORTION

> In the early 1900s, many economists predicted that SOEs would be a relic of the 20th century. They were wrong. SOEs are far from extinction, are thriving, and in many cases seek to expand beyond their borders. National Intelligence Council, *Global Trends 2025: A Transformed World,* p. 10 -11

A new dynamic in the world economy threatens the competitiveness of American companies and workers in world markets and undermines our country's core belief in a market-based economy. This paper lays out that threat – the distortion of competition created by foreign government policy measures favoring state-owned enterprises (SOEs) and state-supported enterprises sponsored as national champions (SSEs). No adequate and effective international disciplines now exist to deal with this problem. This paper provides a comprehensive overview of the SOE/SSE problem and outlines a comprehensive solution.

- **Section I explains the dimensions of the SOE/SSE problem, and its challenge to U.S. trade and investment policy.**
- **Section II identifies strategies to address the SOE/SSE challenge, and sets them in the context of competitive neutrality.**
- **Section III outlines specific negotiating proposals for the ongoing negotiations on the Trans-Pacific Partnership – which will set the benchmark for trade and investment negotiations in the years to come. The TPP agreement must address this challenge if it is to be politically and commercially sustainable as a twenty-first century agreement.**
- **Section IV proposes consideration of new dimensions in U.S. international competition policy through a new advisory group on the interaction between competition and trade policies, which would refine traditional legal doctrine challenged by public-sector restraints of trade, and consider how U.S. agencies can work together on policies and initiatives to prevent government-induced market distortions from adversely affecting U.S. companies and workers in the global market.**

The Fundamental Problem

The National Intelligence Council predicted this trend and its corrosive effect on the competitiveness of U.S. companies and workers in its comprehensive report, *Global Trends 2025.* The market distortions caused by SOEs/SSEs come about in two ways: *regulatory favoritism* and *preferential purchasing and financial support.*

Regulatory Favoritism: The first form of market distortion takes place when government uses policy instruments (such as favorable regulations and subsidies) to change market results, and confer advantages on SOEs because they are state-owned, or otherwise confer advantages on SSEs to create state-sponsored and supported national champions. Government should ensure that there is a level

playing field for all businesses , irrespective of ownership, and not confer competitive advantages on SOEs and SSEs at the expense of private capital, including foreign or foreign-invested competitors. There are many and increasing examples of service sector regulatory and financial favoritism by public bodies affecting the horizontal competitors of private companies.

- Private companies that operate global electronic payment card processing networks must contend with regulatory intervention by central banks and other regulators that favor their government-owned and domestic private competitors – for instance, requirements that all payments must be processed domestically, or only by a central bank, or by a processing network owned by a domestic company.
- Some countries use regulations and directives to exclude international competitors from entering a market or product segment in order to shield its SOE or SSE from direct competition. For example, in India restrictions have been imposed on domestic money transfer so that its SSE, The National Payments Corporation of India, can roll out its own products, unencumbered by competition.
- Some countries give SOEs anti-trust immunity – and use their competition laws to promote their state-owned national champions. For instance, Article 7 of China's 2007 Anti-Monopoly Law requires the state to protect the "legitimate business activities of state-owned enterprises and statutory monopolies."[1]
- Some countries manipulate their standards to favor products or services of their own SOEs, or encourage their SOEs to collude in making standards that exclude competing products or services from the market.
- A number of countries give SOE insurance companies special access to marketing and sales channels, for instance through the postal network in Japan and elsewhere.
- SOE insurance companies also enjoy special regulatory treatment denied to their private sector competitors – for instance in Japan, in India or in China. For example, China's insurance regulator routinely issues multiple licenses simultaneously to SOE insurance firms, while selectively parceling out licenses one by one to foreign-invested firms.
- Some countries place SOEs off-limits for criminal prosecution. The Chinese government fosters a climate of impunity for mass software piracy by China's SOEs and government banks, which save millions every year by not paying for thousands of copies of the business software whose use is essential to their businesses.
- State-owned postal delivery firms around the world benefit from legacy assets, including real estate, and from regulatory favoritism benefiting their products and services that compete with private sector delivery firms.
- Some countries use investment restrictions to force the transfer of technology to their own SOEs. In many sectors in Vietnam, the government allows foreign investment only through joint ventures – for which a SOE is often the only available partner.

---

[1] Mark Williams, "Foreign Investment in China: Will the Anti-Monopoly Law be a Barrier or a Facilitator", 45 Texas Int'l Law J. 127 (2009) at 136.

Today wealth is moving not just from West to East but is concentrating more under state control. In the wake of the 2008 global financial crisis, the state's role in the economy may be gaining more appeal throughout the world...These states are not following the Western liberal model for self-development but are using a different model—"state capitalism." National Intelligence Council, Global *Trends 2025: A Transformed World,* pp. 8-9

Preferential purchasing and financial support: The second form of market distortion takes place when SOEs or SSEs are steered by explicit or implicit government mandates, incentives or informal guidance in their purchasing, sales, technology licensing or other business decisions – or when non-market financing or guarantees provided by government policy enables these firms to operate without any economic rationality. The market distortion here affects foreign companies selling to, or purchasing from, these favored businesses, or foreign companies that compete with their favored domestic suppliers or customers.

Examples of such actions by or for SOEs or SSEs include:

- The Chinese government mandates or induces Chinese SOEs to maintain buy-Chinese policies.
- Chinese SOEs provide inputs to domestic customers at below-market prices, or at prices that would be unsustainable without unlimited financing from state-owned financial institutions.
- The Chinese government mandates that all electronic transactions denominated in RMB must be made through China Union Pay (CUP). Also, when Chinese travel overseas, their transactions in foreign currencies must be handled by CUP.
- Post offices or government-owned transportation companies provide special shipping rates for domestic goods or for domestic companies.
- State-owned banks in China and elsewhere provide below-market policy lending to SOE and SSE producers and service suppliers.
- State trading entities in agriculture can operate as monopoly buyers and sellers. The government allows them to run producer pools, which give them marketing flexibility, reduce market risk, save them money, and allow them to price-discriminate with market power in international commodity markets.
- SOE insurance firms may enjoy government guarantees or government resources that permit them to underwrite more insurance and take on more risk, bankrolled by the public purse. The Life Insurance Corporation (LIC) in India, a government-owned company, has a direct sovereign guarantee backing the life insurance products that it sells; private sector competitors have no access to such a guarantee.

These market distortions are also compounded by two related issues in the policy environment around SOEs and industrial policies. First is the non-transparent environment in which these two types of market distortion take place – often combined with gaps or failures in the rule of law. Governments that devote resources to favored SOEs and SSEs, and regulators that give them preferential treatment, do not want to be accountable for their actions to the public, to non-favored firms, to other governments or to the WTO or under bilateral and regional trade and investment agreements. They make it difficult for outsiders to know the dimensions of the market distortion, who benefits, how much, and whether there was a quid pro quo involved. Second is the use of (non-transparent and informal) administrative guidance by government bureaucracies using the leverage provided by discretionary regulation, or by the government's ability to provide assistance.

> Governments that highly manage their economies often have an interest in industrial policy. China, Russia, and the Gulf states have state plans to diversify their economies and climb the value-added ladder into high technology and services sectors. The significant difference between today's efforts and those of earlier periods, however, is that these states now directly own the economic wherewithal to implement their plans and need not rely on incentivizing parties or luring foreign capital. National Intelligence Council, *Global Trends 2025: A Transformed World,* p. 10

These market distortions now most strongly affect firms competing with SOEs on their home turf. But as SOEs and SSEs grow, they are increasingly competing in third markets abroad and they are beginning to compete in the U.S. market. The U.S. government will need to address these new anti-competitive effects. In addition to new rules in bilateral, regional and multilateral trade and investment agreements, U.S. authorities will need to be equipped to evaluate and take action when foreign SOEs/SSEs are using their domestic anti-trust immunity, dominance of markets abroad, state subsidies, home market share, or legacy assets inherited from the government, as springboards to anti-competitive conduct in the U.S. and foreign markets.

But the stakes in the TPP could not be higher. A successfully concluded TPP will set the benchmark for twenty-first century bilateral, regional and multilateral trade and investment agreements which help U.S. companies and workers overcome the severe and continuing obstacles in competing with SOEs and SSEs. The TPP negotiations make it a near-term priority to achieve an integrated approach in the TPP that addresses the challenges posed by SOEs and SSEs, in order to achieve a level playing field for private sector competitors.

As explained in the attachment to this paper, current international trade and investment laws governing the operation of SOEs and SSEs are outmoded and do not provide adequate and effective rules to operationalize national treatment and to remove market distortions to achieve a level playing field. **The business community and governments need to look to new ways to apply existing rules, together with new rules to address the SOE/SSE problem, including competitive neutrality, a key principle singled out by the OECD in its work on SOEs and corporate governance. The concept of competitive neutrality means that government-supported business activities should not enjoy net competitive advantages over their private sector competitors.**

As OECD reports have pointed out, when there are no mechanisms in place to promote and guarantee competitive neutrality, most SOEs enjoy unearned competitive advantages. They may enjoy favorable tax regimes or outright subsidies. They may benefit from the free use or succession to state assets such as land use. They may get concessionary financing from government or from government-controlled financial institutions. They may be exempt from regulatory regimes such as antitrust enforcement, building permit rules, zoning regulations or disclosure regulations. They may benefit from government procurement preferences and/or from preferential access to information. They may be protected monopolies, and even when competition is allowed, they may be former monopolies benefiting from advantages of incumbency. They are not subject to market disciplines like private businesses – they may not pay dividends or a market rate of return to shareholders, they may be able to engage in predatory pricing with immunity from prosecution, and their management can operate inefficiently without fear of being ousted. They are often exempt from bankruptcy rules, and can generate losses for a lengthy period without fear of going bankrupt.

SOEs, SSEs and their foreign government backers raise serious issues for the international trade, investment and competition regimes, and for U.S. trade, investment, and competition policy. We need to diagnose the problem correctly, and respond firmly and consistently. Our response must be grounded in consistent, market-based principles and remedies that point toward an outcome that reduces or eliminates market distortions. This paper sets out a possible set of objectives, evaluates the existing legal tools available to the USG and proposes a course of action.

As explained in the attachment to this paper, current international trade and investment laws governing the operation of SOEs and SSEs are outmoded and do not provide adequate and effective rules to operationalize national treatment and to remove market distortions to achieve a level playing field. **The business community and governments need to look to new ways to apply existing rules, together with new rules to address the SOE/SSE problem, including competitive neutrality, a key principle singled out by the OECD in its work on SOEs and corporate governance. The concept of competitive neutrality means that government-supported business activities should not enjoy net competitive advantages over their private sector competitors.**

As OECD reports have pointed out, when there are no mechanisms in place to promote and guarantee competitive neutrality, most SOEs enjoy unearned competitive advantages. They may enjoy favorable tax regimes or outright subsidies. They may benefit from the free use or succession to state assets such as land use. They may get concessionary financing from government or from government-controlled financial institutions. They may be exempt from regulatory regimes such as antitrust enforcement, building permit rules, zoning regulations or disclosure regulations. They may benefit from government procurement preferences and/or from preferential access to information. They may be protected monopolies, and even when competition is allowed, they may be former monopolies benefiting from advantages of incumbency. They are not subject to market disciplines like private businesses – they may not pay dividends or a market rate of return to shareholders, they may be able to engage in predatory pricing with immunity from prosecution, and their management can operate inefficiently without fear of being ousted. They are often exempt from bankruptcy rules, and can generate losses for a lengthy period without fear of going bankrupt.

The way forward

The rise of SOEs and SSEs and their potential for distorting trade and investment make it imperative to negotiate new rules to govern their behavior. These new rules should be based on the fundamental principle of national treatment reinforced by rules ensuring competitive neutrality. **Based on past efforts to try to deal with SOE-related problems, the most effective way to address SOE/SSE issues is to do so head-on in the context of obligations, which would be incorporated into new bilateral, regional and multilateral agreements and into existing agreements to bring them up to date.**

Current initiatives provide a number of promising **venues for promoting competitive neutrality and incorporating the disciplines and rules below:**

- U.S. FTAs and BITs: SOE provisions aimed at guaranteeing meaningful market access and conditions of competitive neutrality should be included in the Trans-Pacific Partnership, the

bilateral investment treaty negotiations with India and China, and the U.S. model BIT.[2]

- Foreign FTAs and BITs: Because other significant actors, such as the EU, are actively building their FTA and BIT networks, the U.S. government and private sector should engage in discussions with their counterparts to encourage inclusion of similar market access and competitive neutrality provisions in their international trade and investment agreements. The competition chapter in the EU-Korea FTA includes provisions dealing with SOEs, and further work could have a synergistic effect with strong U.S. FTA chapters.
- The OECD: Building on the extensive work already underway in the OECD on SOEs, the OECD should launch negotiations for a comprehensive competitive neutrality agreement. The United States should also push for China, India, Russia and additional non-OECD countries to accept and implement the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions; and should push for additional countries to participate in the OECD Arrangement on Officially Supported Export Credits.
- The WTO: Launch initiatives to bind countries to the principle of competitive neutrality for their SOEs/SSEs.

Identifying the problem is not enough – we need to understand the impact it is having on U.S. competitiveness and devise strategies to address it effectively. To evaluate effectiveness we need to identify our immediate and longer-term objectives and measure effectiveness in relation to those objectives.

The Administration is now engaged in negotiating the Trans-Pacific Partnership with the objective of producing a "twenty-first century trade agreement." These negotiations involve some countries with a history of major involvement by the state in the national economy, through state-owned manufacturing and services businesses: for instance, Singapore, Malaysia, Peru, Chile, and of course Vietnam. On the other hand, Australia has a history of commitment to effectively guaranteeing a level playing field for private businesses that compete with government and SOEs and SSEs.

The U.S. business community and U.S. government must work closely together to develop new and comprehensive obligations to discipline the activities of SOEs and SSEs, to ensure competitive neutrality in—

- **A party's home market,**
- **The markets of other parties to the agreement, and**
- **Third country markets.**

The obligations should be based on consultations with U.S. businesses to determine the scope and dimensions of the problem; on extensive work already done by the OECD and the Australian government on competitive neutrality; and on the analysis in this paper of existing obligations. They are not intended to replace or interfere with the operation of other international agreements intended to promote competitive neutrality, such as the WTO SCM Agreement.

[2] The U.S. model BIT should include the improvements suggested by the U.S. Chamber of Commerce in its analysis provided during the 2009-2010 BIT review process -- improvements designed to enhance BIT disciplines on SOEs and national champions.

III. Proposals for the TPP negotiations

The TPP negotiations present an immediate need to address the market access and competitive neutrality challenges, in both goods and services trade, presented by SOEs and SSEs. The TPP negotiating partners include countries with extensive government-business involvement and active industrial policies. As a result, **the TPP provides a unique opportunity to address these challenges and to set a precedent for future bilateral, regional and multilateral agreements. If the TPP agreement does not address these real phenomena, it will provide only one-sided open trade giving SOEs and SSEs unencumbered access to the U.S. market, while denying fair trade and investment opportunities to U.S. firms and their employees; and, perhaps even more importantly in policy terms, it will send a strong signal that that the United States does not intend to address the 21st century challenge of SOE distortions in world markets.**

"Free trade" without real competitive market access is not economically and politically sustainable for U.S. businesses or workers, nor politically sustainable for the U.S. government and in particular, Congress. A one-sided and inadequate TPP that gives away the opportunity for economic growth and job creation to foreign SOEs and SSEs would be a disaster. It would not only fail to fulfill the Administration's promise of a "twenty-first century trade agreement" – it would fall short compared to even the first steps to deal with these issues in the Singapore and other FTAs of prior administrations. It would also represent a major lost opportunity to develop new rules to ensure fair competition for American companies and workers.

We propose that U.S. TPP negotiators address the challenge of SOEs and national champions in two ways.

- **The TPP commitments should include a package of problem-solving provisions addressing the practical market access and market distortion problems caused by government intervention in favor of SOEs and SSEs, and the actions of SOEs and SSEs in the commercial marketplace.**

These commitments must be enforceable through dispute settlement, just like the other TPP commitments – otherwise they will not be credible.

- **To set these commitments into the larger context of competitive neutrality, the TPP should include specific commitments on competitive neutrality drawn from the work underway in the OECD, and should create an ongoing forum to further develop these commitments and to address competitive neutrality issues under the agreement as they arise.**

SOE/SSE package to assure market access and competitive neutrality for goods and services trade
The TPP and future bilateral and multilateral agreements should include a SOE/SSE package that addresses the impact on investment and market access of SOEs and government intervention in favor of SOEs or SSEs. This is needed because the issues concerned span both goods and services; in the services area, these issues affect services delivered through foreign direct investment, commercial presence, and services delivered cross-border. From a practical standpoint, framing these obligations as trade and investment obligations sets them in their proper economic and political context, as obstacles and distortions to trade and investment in the commercial marketplace. The tailored SOE/SSE package would include the following obligations (which would be subject to non-conforming measures as negotiated and set out in a negative list).

Disciplines on SOEs and SSEs:

- SOEs and SSEs would be defined as a "public body engaged in commercial activity" in cases where an enterprise
    1. is majority owned by a government, or is *de jure* or *de facto* controlled by a government, or
    2. is granted special or exclusive rights (including when a government limits the number of enterprises authorized to provide goods or services, other than according to objective, proportional and non-discriminatory criteria); or-
    3. is granted special legal or regulatory advantages that affect the ability of any other enterprise to provide the same goods or services; or
    4. acts under the influence of a government in accordance with state-developed industrial policies;

    <u>and</u>

    is engaged in commercial activities, or in purchasing goods and services for the purpose of engaging in commercial activities.

- Each party to the TPP would be obligated to notify the other parties of all of its public bodies engaged in commercial activity that are existence as of the date of entry into force of the agreement, and must notify any such public body that arises after that date (for instance, such public bodies created through nationalization or by the grant of special or exclusive rights or advantages).
- Where actions of a TPP party will give rise to a public body engaged in commercial activity, and the status or benefits to that public body may affect the interests of persons of another party, the TPP party must:
    1. at the time of its actions, impose such conditions on the operation of that public body as will eliminate any nullification or impairment of market access provided under the agreement for goods, services or digital products; and
    2. ensure that the operation of that public body does not nullify or impair that market access.
    3. These conditions would have to prevent the public body in question from unfairly exploiting legacy monopoly assets or market positions or engaging in anticompetitive pricing, output restriction or other exclusionary conduct.
- Each party (and its government-owned or -controlled financial institutions) must not provide financial support on non-commercial terms to any public body engaged in commercial activity.
- Each party must ensure that any public body engaged in commercial activity:
    1. Acts in a manner consistent with the party's TPP obligations (including nondiscrimination and market access commitments) whenever the public body exercises any regulatory, administrative or governmental authority; and

2. Accords non-discriminatory treatment[3] to covered investments, to goods of another party, to service suppliers of another party and to digital products:
    - in its purchases of goods of other TPP parties, of services from service suppliers of other TPP parties, or of digital products; and
    - in its sales of its goods or services to covered investments or its sales of digital products.
3. Complies with intellectual property obligations provided for in the agreement, including not using infringing or unlicensed computer software or other copyrighted materials.

- The agreement would provide that:
    1. The treatment to be accorded by a party under the national treatment obligation in the investment chapter means treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that party to a public body engaged in commercial activity, and to investments of such a public body; also, that if a public body engaged in commercial activity and a private enterprise are competitors in the market, they are in like circumstances;
    2. The treatment to be accorded by a party under the national treatment obligation in the chapter on market access for goods means treatment no less favorable than the most favorable treatment accorded to goods of a public body; and
    3. The treatment to be accorded by a party under the national treatment obligation for cross-border services means treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that party to a public body engaged in commercial activity.
- With respect to any SOEs or SSE determined to be a "public body engaged in commercial activity", the parties would also be prohibited from adopting any measure that restricts competition, or authorizes anti-competitive agreements or concerted activity with the intent or effect of restraining competition, insofar as this restricts trade or investment between the parties and with third parties.
- The parties would also be required to ensure that these enterprises are subject to the competition laws.
- The agreement should also provide for an independent regulator to prevent SOEs and SSEs from unfairly exploiting legacy monopoly assets or market positions, or engaging in anticompetitive pricing, output restriction or other exclusionary conduct.

Rules to ensure competitive neutrality

- As in the KORUS and Singapore FTAs, there should be rules that obligate the parties to have comprehensive competition laws that proscribe anticompetitive conduct, and provide for due process in antitrust investigations and enforcement actions.
- Parties would be barred from providing any exemption from laws and regulations, for any state enterprise engaged in commercial activities, unless such exemptions are granted on a national treatment basis.

---

[3] "Non-discriminatory treatment" means: for goods, national treatment as defined in the chapter on market access; for services and service suppliers, national treatment as defined in the chapters on cross-border services and investment; and for digital products, the non-discriminatory treatment required in the chapter on e-commerce.

- The TPP would incorporate the principle of competitive neutrality, and would call for SOEs to be operated in accordance with OECD guidelines established for SOE governance.
- The TPP should also encourage parties to reduce their ownership in SOEs, and should prohibit governments (and government-owned or -controlled financial institutions) from providing financial support to SOEs and SSEs on non-competitive commercial terms.
- The TPP agreement should create a Standing Committee on SOEs and Competitive Neutrality, with members drawn both from competition agencies and from trade agencies. The Standing Committee should meet regularly to discuss issues related to applying the competitive neutrality principle; to discuss and resolve market access and market distortion problems caused by SOEs, SSEs and government intervention in their favor before such problems ripen into fully-developed disputes; to coordinate action among the parties; to conduct a biennial review of these issues; and to develop plans to correct problems revealed in the reviews. The biennial reviews would be released upon their conclusion.

Non-conforming and prudential measures: Exceptions to the market access obligations above should only be recognized for a limited set of measures, to be negotiated on a negative list basis and recorded explicitly as non-conforming measures. These could include public policy exceptions for non-protectionist objectives such as aid to small and minority businesses, measures in sectors such as natural resource extraction recognizing unique or long-standing SOE/SSE relationships, and U.S. state and local measures.

In addition to the standard provisions permitting prudential measures, an escape clause providing flexibility on a temporary basis in economic emergencies should also be considered, though the use of emergency exceptions must be specifically limited in duration and subject to loan repayment. In addition, public bodies engaged in commercial activity could be exempted or partially exempted from the obligations when procuring products or services for governmental purposes and not with a view to commercial resale or to use in the production of goods or services for commercial sale.
The agreement would require that any new measures sheltered by these exceptions should not be implemented until they have been notified to the other parties.
Enforcement and the need for certainty: The TPP must include a timely, structured and transparent system of government-to-government dispute settlement, of course, and that would apply to the SOE chapter as well. **Remedies** should be structured along the lines of the remedies available under the WTO and FTA dispute settlement systems.

- A party found to be out of compliance would be obligated to bring itself back into compliance with the TPP as interpreted in dispute settlement proceedings. The penalty for failure to comply within a reasonable period of time would be authorization for the aggrieved party to suspend TPP concessions until compliance, or until a mutually acceptable settlement agreement is reached.
- To compensate competing private sector businesses damaged by a failure to provide competitive neutrality, and to provide an incentive not to delay compliance, consideration should be given to adding a damages remedy.

IV. Rethinking international competition policy

Ensuring a 21st Century U.S. Antitrust Law: Because competitive neutrality issues reflect an intersection of competition policy and trade policy, the U.S. government should commission an advisory committee on competition and trade policy, to advise an interagency group comprised of the Attorney General,

USTR and other agencies as appropriate. The advisory committee would focus on the interface between competition and trade policy, and on what policy and legal tools need to be developed and deployed to eliminate market distortions affecting U.S. business and labor due to anti-competitive practices of foreign governments and SOEs and SSEs. This committee would be modeled on the successful International Competition Policy Advisory Committee, which did groundbreaking work ten years ago on similar issues. Emerging issues require fresh thinking on the interaction of competition and trade policies:

- Public-Sector Restraints of Trade: The rise of state-led economic development models which use an array of industrial policy tools to produce national champions, many of which are state-owned enterprises, poses an increasing challenge to creating a level playing field in the U.S. and foreign markets. These developments raise important issues with regard to legal interpretations premised on a non-interventionist role of the state in the economy, the concept of "commercial considerations" in trade and investment agreements, and the application of the Foreign Sovereign Immunities Act and the "state action doctrine." In particular, new thinking should be devoted to consider how best to clarify the "state action doctrine" to ensure that public bodies are not immune from the jurisdiction of the courts of the United States for conduct that is deemed to be a commercial activity (i.e., an activity that is of the type customarily engaged in by private persons for profit).
- Interagency Process: These developments also highlight the need to review the interagency process with regard to cooperation and collaboration on competition policy matters outside specific antitrust enforcement cases. The commission could consider means and structures for collaboration between the Department of Justice, the Federal Trade Commission, the Office of the United States Trade Representative, the Departments of State and Commerce, and the National Economic Council, to develop and implement policies and initiatives to prevent government-induced market distortions that adversely impact U.S. companies and workers in the global market.

Background: Trade laws and the SOE/SSE problem

Trade and investment laws provide some tools to deal with market distortions caused by government measures favoring SOEs, and by SOEs themselves, but they are not adequate and effective to deal with the twenty-first century dimensions of this problem. The provisions usually considered most specific to SOE behavior -- in Article XVII of the GATT -- in fact only address a limited piece of the problem and have never been very useful as a source of discipline. Otherwise, WTO rules provide tools to address discrimination, local content and procurement mandates, and subsidies to and by SOES. But they do not address the structural aspects of the SOE problem, they do not guarantee access for investments, and they do not protect investments against the un-level playing field created by SOE-based industrial policy.

The problem occurs when government itself intervenes in the marketplace to subsidize SOEs or domestic national champions, or to discriminate in their favor in domestic taxation, regulations, or other legal requirements. It also occurs when SOEs (including state-owned banks) or national champions engage in such subsidization or discrimination.

WTO provisions on "state trading":

GATT Article XVII–a compromise deal made at a time when many countries channeled trade in some or all products through state trading organizations – is limited in scope and ambition. It focuses on

behavior of state *trading* enterprises (STEs), not on structure or on behind-the-border barriers, and it does not deal at all with trade in services.

The GATT and WTO interpretation of GATT Article XVII has been disappointing. Although Article XVII requires that any STE or enterprise that is granted exclusive or special privileges "shall, in its purchases or sales involving either imports or exports, act in a manner consistent with the general principles of non-discriminatory treatment prescribed in [the GATT] for governmental measures affecting imports or exports by private traders", the WTO has interpreted this obligation as a loose form of most-favored nation treatment. Moreover, the WTO has refused to read Article XVII as imposing a requirement for STEs to make purchases or sales in accordance with commercial considerations; the leading decision on Article XVII, *Canada-Wheat*, found that until a complaining party proves that there has been a failure that to act in accordance with principles of non-discriminatory treatment, commercial considerations are not relevant.[4] The WTO has also refused to interpret Article XVII so as to prevent export STEs from using their exclusive or special privileges to the disadvantage of commercial actors.[5]

Other trade law rules:

In this situation, governments and stakeholders have invoked other trade law rules that deal with SOE-related market distortions. They have looked to GATT Article II:4, which requires that a WTO Member not operate any **import monopoly** "so as to afford protection" beyond the agreed tariff rate. Article II:4 bans monopoly markups on imports, or any other non-tariff barrier that inflates import prices.

Governments and stakeholders have also looked to the **national treatment rules for trade in goods** in GATT Article III, to challenge regulations or local content requirements or incentive schemes that discriminate against imported goods. GATT Article III requires each WTO Member to accord to imported goods the *best* treatment given to like domestic products – for instance, especially favorable treatment given to products made by or traded by domestic SOEs or national champions. For instance, in the *Turkey – Rice* case, a WTO panel ruled that by giving favorable TRQ treatment to firms that (inter alia) purchase rice through the Turkish Grain Board, Turkey was in breach of its obligations under Article III.[6]

Under the GATS rules on **national treatment for trade in services,** the benchmark for comparing treatment to suppliers should be the treatment given to the most-favored domestic supplier.[7] There have been no WTO challenges to services SOEs yet. However, when a government provides favorable treatment to its own services SOEs – which are inherently domestic service suppliers – the national treatment rule should require it to give no less favorable treatment to the private companies that compete with the SOE and are therefore "like" service suppliers. When a government or an SOE consciously targets the SOE's foreign or foreign-invested competitors, and seeks to exclude them from

---

[4] WTO Appellate Body Report, *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain* (*Canada – Wheat)*, WT/DS276/AB/R (Aug. 30, 2004), ¶139-143, 145.

[5] WTO Panel Report, *Canada-Wheat*, WT/DS276/R, ¶6.103.

[6] Panel Report, *Turkey – Measures Affecting the Importation of Rice,* WT/DS334/R, ¶7.227-7.241.

[7] For instance, in the *EC – Banana* case, the group of less-favored banana distributors could have included EC-origin firms that had not traded EC/ACP bananas. When the panel compared the treatment accorded Ecuadoran and U.S. banana distributors, its benchmark was not the treatment to less-favored EC firms, but the treatment to the most-favored EC firms.

the SOE's market, this fact in itself demonstrates that the SOE and its private sector competitors are head-to-head competitors and are therefore "like" for the purpose of national treatment obligations.

WTO's Agreement on Subsidies and Countervailing Measures (SCM Agreement). Moreover, the SCM Agreement's definition of subsidy also includes **financial contributions conferred by any "public body"**. A WTO panel recently found that **"public body" includes any SOE or other government-controlled entity**. As a consequence, the SCM rules on subsidies apply to financial contributions by these "public bodies" in China or elsewhere, including provision of inputs or financing to private companies at below-market prices, or purchases from private companies at above-market prices. The Department of Commerce has evaluated the benefit from such subsidies in China by using non-distorted prices from outside China; a WTO panel recently found that this evaluation method is WTO-consistent under *general* SCM rules (and therefore could be used in other countries where high SOE presence distorts markets).[8]

A subsidy that is limited in law or in fact to SOE manufacturers, or to a particular SOE, is "specific."[9] These specific subsidies, which are a major component of SOE-related trade distortion, are all potentially countervailable, actionable and/or prohibited by WTO rules.

Subsidies given to SOEs as service suppliers are subject to the GATS national treatment rule, and must be equally available to like services suppliers of any other WTO Member if the government in question has so committed to national treatment for that sector.

WTO accession agreements have also addressed the SOE problem. In the case of many transition economies and non-transition economies with heavy SOE presence, the acceding country has had to agree to notify its remaining SOEs and its privatization process.[10]

The most extensive commitments regarding SOEs are those undertaken by China, which agreed to an obligation to ensure that state-owned and state-invested enterprises would make purchases and sales based solely on commercial considerations, and other WTO Members' enterprises will have an adequate opportunity to compete for sales to and purchases from these enterprises on non-discriminatory terms and conditions. The phrasing of the obligation regarding "commercial considerations" makes it clearly an independent obligation, unlike the similar obligation in Article XVII. China's current policy push for SOEs to favor products of "indigenous innovation" in their purchasing would appear to breach these

---

[8] *U.S. – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China ("US-AD/CVD (China)")*, WT/DS379/R, ¶10.105-10.130. Paragraph 15(b) of China's Accession Protocol allows an importing country to apply different benchmarks to measure "benefit" if the usual methodology is difficult to apply in the context of China's economy, but the parties did not invoke this provision and the panel did not rule on its application. *Id.,* ¶10.10-10.12.

[9] Import Administration Policy Bulletin 10.1, "Specificity of Subsidies Provided to State-Owned Enterprises", text available at http://ia.ita.doc.gov/tlei/bulletins/PB-10.1.pdf (also states that the Department will normally consider a subsidy to be specific as a matter of fact if SOEs are a predominant user of the subsidy or SOEs receive a disproportionately large amount of the subsidy).

[10] WT/ACC/10/Rev.4/Add.1, May 25, 2010, p. 11-16 (acceding Members: Mongolia, Bulgaria, Kyrgyz Republic, Latvia, Estonia, Georgia, Albania, Croatia, Lithuania, Moldova, Armenia, Chinese Taipei, Former Yugoslav Republic of Macedonia, Cambodia, Saudi Arabia, Ukraine, Cape Verde).

obligations; however, it remains to be seen whether the U.S. or any other government will be willing to bring a WTO challenge on this basis.

China also agreed that purchasing for commercial or non-government purposes by its SOEs (or by state-invested enterprises) is not "government procurement" and is therefore subject to national treatment rules for goods and services. This means that a government buy-Chinese mandate imposed on a Chinese SOE would violate China's WTO obligations (even if the mandate is imparted through informal government administrative guidance). Commitments like these which nominally go beyond the letter of the existing WTO (but compensate for the real gaps in delivered market access in China) are legally possible and appropriate because they are made in the context of an accession package, which determines the terms under which WTO rights and obligations will apply to China. An accession protocol commitment like these does not *follow* WTO rules, it *makes* WTO rules.

Tough bargaining in accession negotiations remains essential to obtaining provisions on meaningful market access in SOE-dominated transition economies, and strong followup is even more essential to ensure that these provisions yield real, nondiscriminatory market access. Russia's WTO accession negotiations are the next task as the business community pursues real market access there.

FTAs

Free trade agreements have come the closest to tackling the SOE issue in a meaningful manner. The **Singapore-U.S. FTA competition chapter** pioneered with SOE provisions because the subject was inescapable given the high presence of SOEs in Singapore's economy – including sovereign investment vehicles. The Singapore chapter went beyond provisions on competition legislation and due process, to include special provisions on designated monopolies (including where a private company is designated as a monopoly) and on government enterprises. These provisions, which bound both parties, focused on their impact on competition outside the monopoly area, and on market access under the FTA. In addition, Singapore undertook that its government enterprises would act solely in accordance with commercial considerations in their purchases and sales; that these enterprises would not engage in anticompetitive conduct; that Singapore would not intervene to influence decisions of these enterprises; that Singapore would consider reducing its aggregate ownership of Singapore entities; and that Singapore would report annually on its government ownership.

Later FTAs, notably the **Korea-U.S. FTA**, have also addressed the SOE problem. The KORUS provisions simply require that any state enterprise of either party comply with KORUS obligations when it exercises regulatory, administrative or other governmental authority that the government has delegated to it, and accords nondiscriminatory treatment in the sale of its goods to covered investments.
Also of interest are the more ambitious provisions that Korea and the EU have agreed to in the **competition chapter of the Korea-EU FTA**. Because SOEs are a key subject for EU competition law, and EU competition law links to market access within the EU, this chapter explicitly obligates the parties to apply their competition laws so as to prevent anticompetitive business conduct from removing or eliminating the benefits of the trade liberalization process – and it requires them to apply this obligation, and to apply competition laws, to "public enterprises and enterprises entrusted with special or exclusive rights." The Korea-EU chapter also requires state monopolies of a commercial character to be adjusted so that any discrimination in procurement or sales of goods does not affect persons of the FTA parties. Because EU competition law also regulates state aids (subsidies), the Korea-EU competition chapter also regulates subsidies, prohibiting unlimited bailouts and subsidies to insolvent enterprises without a credible restructuring plan where the enterprise contributes to the restructuring cost.

These efforts provide valuable precedents for attacking the challenge of SOEs and national champions in the TPP. But TPP rules dealing with this topic need not be pigeonholed in the competition chapter. Every one of the trade and investment market access chapters in the TPP needs to be reviewed from this viewpoint, including goods market access, cross-border services, financial services, telecom services, procurement and investment. The challenge of SOEs and SSEs must also be taken into account in framing the other systemic chapters – for instance standards, intellectual property, transparency, competition – or perhaps a separate chapter on SOEs. **The TPP agreement must address the SOE/SSE challenge if it is to be politically and commercially sustainable as a twenty-first century agreement.**

Discussion Paper:

Cross-Border Data Flows and Trade in Services

Introduction

Global cross-border trade in services has grown strongly in recent years. From 2003 to 2008, world exports of services more than doubled, jumping from $1.8 trillion to $3.8 trillion, before falling back to $3.3 trillion in 2009. (WTO data). Trade in these services, which include transportation and travel, insurance and other financial services, telecommunications and IT services, business professional and technical services, royalties, license fees and many other services, has yielded clear global economic benefits.

The explosion in global services trade has largely been enabled by the development of fast, efficient and cost-effective electronic communications networks. In fact, almost half of cross-border trade in services worldwide is enabled by ICT services, and is increasing rapidly, according to the UN Conference on Trade and Development (UNCTAD).

The group of services enabled by information and communications technology extend far beyond computer and related services and telecommunication services. As the European Centre for International Political Economy has pointed out, a sampling of ICT-dependent services would include financial analysis, engineering, research and development, insurance claims processing, design, education, publishing, medical services and journalistic work.

Robust ICT networks enable knowledge and expertise to cross borders in all these activities. As such, cross-border trade in these services is, fundamentally, the exchange of data across borders. Innovative firms in many services industries are increasingly able to use data to more effectively serve customers around the world, reduce transaction costs and improve efficiency. This has in turn driven economic growth, productivity and innovation.

However, the tremendous increase in cross-border data flows that has accompanied burgeoning services trade has raised concerns on the part of many governments. Some are enacting, or considering, restrictions on such flows on the basis of privacy, consumer protection, security or other reasons. Given that cross-border services trade is, at its essence, the exchange of data, unnecessary restrictions on data

flows have the effect of creating barriers to trade in services. As this paper explains, there are a number of possible mechanisms to ensure that data flows, and the services trade that depends on them, can continue.

Restrictions on cross-border data flows could become a major barrier to trade in services. International trade in many services depends on cross-border data flows between service providers and their clients. Electronic delivery of services across borders is simply not possible without the ability to send and receive information over networks. While a government might make cross-border services market access commitments in trade agreements, if it blocks or severely restricts data flows unnecessarily, those commitments would be undermined and would provide no benefit to multinational service providers. While governments have the right to regulate, they should rely on market forces, voluntary best practices and public-private partnerships whenever possible. When regulation is necessary, it should be done in the least-trade-restrictive way possible.

There are many reasons why a government might want to block or severely restrict cross-border data flows. The Internet and advances in information technology have given rise to many important and challenging issues. Some cross-border data issues that may concern governments include:

1. Data privacy
2. Cyber security / network security
3. Consumer protection
4. Regulatory concerns (e.g., jurisdiction, access to information, data retention requirements, prudential issues, electronic commerce)
5. Cyber crime
6. Access to information by law enforcement (both stored data and real-time communication)
7. Promotion of domestic cultural content
8. Restrictions on political speech
9. Censorship of content that is deemed harmful or illegal
10. Prevention of spam
11. Tax collection
12. Industrial policy / economic development / local job creation / localization

Many of these issues fall under the exceptions to trade-in-services commitments. Governments may have legitimate reasons to block or restrict cross-border data flows. Unfortunately, many of these measures they might take are likely to fall under the exceptions to WTO GATS commitments that allow governments to regulate the provision of services, provided that the restriction is narrowly tailored to fit the exception and is not applied in an overbroad and unjustified manner. These exceptions, found in GATS Article XIV, Article XIV *bis* and the Annex on Financial Services, include:

1. Protection of the privacy of individuals
2. Protection of essential security interests *taken in time of war or other emergency in international relations* (*Note*: Italics added. This could be interpreted very broadly in the context of cyber security, especially given frequent hacker attacks against both government and commercial entities.)
3. Compliance with laws or regulations
4. Protection of public morals
5. Maintenance of public order
6. Protection of public safety
7. Protection of human, animal or plant life or health
8. Prevention of deceptive and fraudulent practices
9. Dealing with the effects of a default on services contracts
10. Equitable or effective collection of taxes on services or service suppliers
11. Financial regulations for prudential reasons or to ensure the integrity and stability of the financial system

New agreements are needed to ensure cross-border data flows. Although the WTO puts some limitations on what a government can do under the WTO GATS exceptions by requiring that measures not amount to "arbitrary or unjustifiable discrimination" and not be a "disguised restriction on trade in services," the exceptions could be interpreted very broadly and might be difficult to challenge successfully in formal dispute settlement cases.

It would be far better to avoid the need for dispute settlement by creating an environment of trust and confidence on the Internet and avoiding unnecessary restrictions on cross-border data flows in the first place. Data flow commitments or non-binding agreements should be negotiated to complement cross-border services commitments and promote responsible and accountable treatment of data. This might be achieved through new provisions in trade agreements, or other arrangements outside of the context of a formal trade agreement, that balance the need to protect data with the right to move data.

There is a wide range of potential mechanisms to enable cross-border data flows. Although including data flow provisions in new trade agreements is one option, other mechanisms might be used to address cross-border data flow issues. In fact, given the range of reasons that governments might want to restrict data flows, it might be necessary to address different issues through different mechanisms.

Depending on the type of data and service, different regulators, law enforcement agencies or other government offices may have jurisdiction, and these different government stakeholders may require different approaches. In some cases, non-binding agreements might be the only option. In this case, government, the private sector and other stakeholders may need to work together to develop approaches to data security and protection that will instill confidence in, and reduce resistance to, cross-border data flows. Such arrangements could reduce the government's perceived need to restrict data flows and provide greater opportunities for cross-border trade in services. Some potential approaches include the following:

1. Trade agreements including binding commitments or frameworks for cooperation (multilateral, plurilateral, regional or bilateral)
2. Binding treaties, including mutual legal assistance treaties
3. Mutual recognition agreements
4. Regulatory cooperation arrangements
5. Voluntary industry principles, guidelines and international best practices, including technological solutions
6. Industry codes of conduct
7. Public-private partnerships
8. Commercial contracts between service providers and customers
9. Multilateral institutions
10. International standards bodies
11. National law or regulation (based on economic self interest)

Given the range of issues that need to be addressed to enable the global digital economy, a combination of the above or other mechanisms may be needed to ensure cross-border data flows. The development of a general or umbrella set of cross-border data principles may be a good place to start, providing useful guidance for enabling data flows, regardless of the mechanism chosen to resolve a specific concern. In addition, private sector stakeholders could prepare an analysis to demonstrate the benefits of open, cross-border data flows and the economic consequences (e.g., higher costs, lower growth, reduced competitiveness, less choice) of blocking or restricting data flows so that governments are less inclined to implement restrictions.

Forced Localization of Global Companies Business Activities

Forced localization is a growing impediment to economic efficiency and commerce globally. Forced localization, in which a country constrains business to require that it be supported and conducted domestically rather than internationally, has focused on goods, but has also spread to the performance of services.

Despite pledges from many governments to restrain such protectionist measures, the 2008 financial crisis has spurred new attempts to force international business activity to be conducted domestically. A recent survey conducted by General Electric found thirty five enacted or proposed new localization measures globally within the past two years.

Many of the newest localization regulations have been enacted in developing economies. Asia and Africa account for more than half of the recently proposed or implemented instances of forced localization policies globally. China has proposed or imposed seven forced localization measures within the past two years, the highest number of any country. Indonesia has proposed or enacted five forced localization measures, the second-highest number.

Developed economies are not immune from the domestic political pressure to enact forced localization rules, however. France, Australia, and the United States have implemented or proposed a combined six local content measures, three of which are in Australia.

The Coalition of Service Industries has engaged with the U.S. government and other governments to oppose local content measures, particularly in Africa where Nigeria's local content restrictions on oil and gas services have influenced neighboring countries to explore implementing their own energy services local content restrictions.

As is the case with other forms of protectionism, forced localization in one country encourages the spread of forced localization to other countries to the detriment of global commerce and the domestic economy alike.

Examples of Global Forced Localization Policies

DATA PROCESSSING

China: Chinese requirement to do on-shore processing of financial services data, which took effect in mid-2008. In addition, China is now requiring foreign financial institutions to have a back-up site in China by March 2011.

South Korea: Without passage of the U.S.-Korea FTA, foreign financial institutions will be required to process South Korean data in South Korea.

Indonesia: Indonesia promulgated a law and regulations that, if implemented, would have required foreign financial institutions to process Indonesian data in Indonesia and also to have a "recovery center" in-country as well. The relevant ministry in Indonesia is no longer moving ahead, but the problematic law and regulations still technically exist.

Turkey: Turkey's banking regulator (BRSA) has adopted a regulation requiring all banks operating in Turkey to conduct all data processing in Turkey with respect to those operations. The regulation is scheduled to enter into force and effect in May 2012.

Turkey: Turkey's anti-money laundering regulator (MASAK) has sent an "opinion" letter to certain foreign financial institutions, requiring end-to-end AML monitoring process' location in Turkey. A MASAK expert has stated that there is a legislative proposal being developed for Turkish AML legislation that would require such compliance from all banks.

Russia: Russia's Finance Committee of the Duma is considering a requirement that, in the implementation of a national payments system, all credit card transactions occurring in the geographic territory of Russia be processed in-country.

CAPITAL/CURRENCY

Thailand: Foreign financial institutions are subject to a requirement that 70 percent of its Thai deposits (liabilities) remain in Thai baht. This requirement is a capital control that forces US financial institutions to invest locally.

South Korea: Foreign financial institutions are severely constrained in their ability to buy forward won contracts. FFIs uses these contracts to hedge currency risk when they takes won and convert it to other currencies to use or invest abroad. The South Korean restriction, in effect, locks capital in South Korea because there is too much foreign exchange risk without the won forwards.

European Union: EU-based hedge funds are now obligated to use an EU-based depositary; non-EU based funds operating in EU may use their "local" depositary, provided a strict equivalence regime is met. This is an issue for US financial institution's depositary businesses.

European Union: The European Commission has been considering, in the context of the European Market Infrastructure Regulation (EMIR) on "Over-the-Counter" (OTC) Derivatives Clearing, requiring derivatives denominated in euros to be cleared in a Central Clearing Party (CCP) located in the eurozone. (That threat has receded somewhat, but remains viable.)

Japan: Japan is considering requiring certain classes of yen-denominated derivatives to be cleared in Japan.

CORPORATE FORM/LICENSING

European Union: An EU regulation require banks using credit ratings for regulatory purposes to use only those ratings that have been "issued by credit rating agencies established in the Community." EU-based ratings agencies may "endorse" a rating carried out in a third country; and there is a stringent equivalence regime permitting the use, in certain circumstances, of ratings wholly produced in a third country. The essential objective of the regulation, however, is to "on-shore" credit ratings.

India: RBI issued a discussion paper on bank subsidiarization. The paper establishes benefits for subsidiaries that would not exist for foreign bank branches and would require mandatory subsidiarization for foreign banks that meet certain specific criteria.

ENERGY SERVICES

Nigeria: A Local Content Development Law for Oil and Gas was enacted in April 2010, requiring foreign oilfield services companies to fill high percentages (80-95%) of their services workers with Nigerians. The

law also specifies local content requirements for equipment and materials used in upstream and downstream oil and gas services.

Ghana: Local content legislation based on the local content legislation passed in Nigeria has been introduced in Ghana.

Kazakhstan: Energy services companies are subjected to economic needs testing for non-local hiring and sub-contracting that create opportunities for corruption.

GOVERNMENT PROCUREMENT

Brazil: Government procurement contracts may favor Brazilian suppliers over foreign firms in all sectors, even if the price is up to 25% higher for domestic services and goods.