**Are SOEs a Red Herring?**

Much has been made of the TPP and NAFTA chapters on state-owned enterprises (SOEs). They are supposed to be forward-looking provisions that will put a dent in state capitalism. But the premise is wrong, and so the response is wrong.

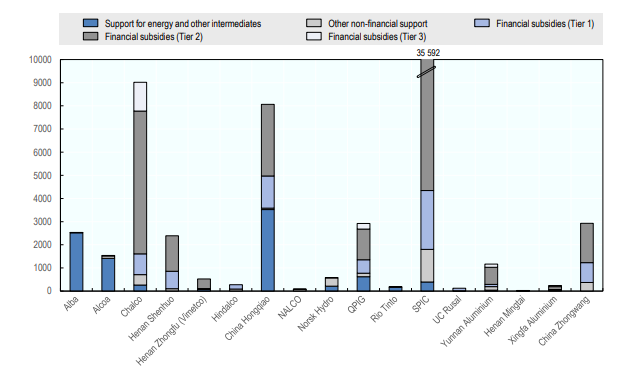
The premise of the argument is that state capitalism is executed through SOEs. In some cases that’s true, certainly. But state capitalism does not have to be executed through SOEs. When you strip all the distractions away, you realize the real problem isn’t state ownership. It’s government control, and anticompetitive behavior.

The [OECD](https://www.oecd-ilibrary.org/docserver/c82911ab-en.pdf?expires=1555538939&id=id&accname=guest&checksum=C61A1EB1B8CD2F6290B09DECB08124F2) is doing some extraordinary research to try to identify subsidy practices around the world. The impetus for the research is “growing interest in updating the international trade rule-book to better address concerns about fair competition in the global economy.” Their most recent report was on aluminum. It gives us unprecedented insight into how governments, including but not limited to China, intervene in the marketplace.

**State Capitalism =/= State Owned Enterprises**

Let’s start with China, because that’s what’s driving the concern with SOEs.

In 2016 the largest aluminum producer in the world was *private* Chinese producer Hongqiao. In fact, Hongqiao’s private status gave it a cachet that led a [gullible Bloomberg reporter](https://www.bloomberg.com/opinion/articles/2016-10-10/china-isn-t-the-reason-u-s-aluminum-is-suffering) to sing its praises as an emblem of the free market. But it turns out that it wasn’t the market that was free – it was the massive quantities of subsidies various Chinese government entities sent Hongqiao’s way. Per the OECD:



With some [financial reporting shenanigans](https://www.spglobal.com/platts/en/market-insights/latest-news/metals/072517-sampp-downgrades-hongqiao-cites-heightened-corporate-governance-risks) thrown in for good measure.

And the financial shenanigans were Hongqiao’s undoing.

Hongqiao had a good deal of trouble keeping any auditors around. With no certified books, the company was in danger of defaulting on its debt. Who should swoop in and save the company from itself? [Why, a Chinese state-owned enterprise, of course.](https://www.scmp.com/business/companies/article/2107035/citic-group-extends-us102-billion-financial-lifeline-worlds)  Hongqiao is now formally a state-owned enterprise. But the lesson here is that it always was. Informally.

Now let’s look at the Russians. Rusal, a private firm, held the title of largest aluminum company in the world until it was supplanted by the aforementioned Hongqiao. Still, Rusal was doing ok – until the U.S. government [slapped sanctions](https://home.treasury.gov/news/press-releases/sm0338) on its owner, Oleg Deripaska, for meddling in our democracy. But there was no need to worry about the fate of Rusal, because Team Putin made it quite clear that if the company went under, [it would be backstopped by the Russian government](https://www.reuters.com/article/us-usa-russia-sanctions-rusal-en/moscow-may-provide-some-support-for-deripaskas-rusal-gaz-idUSKCN1IF0XW).

Aluminum provides the best examples of this kind of behavior, in part because of the OECD’s research. But it’s not just aluminum. Or manufacturing. Look at the [proposed merger between two German banks](https://www.nytimes.com/2019/03/17/business/dealbook/deutsche-bank-commerzbank-merger-germany.html), which the New York Times described as potentially creating

a new national champion lender that could support the country’s huge export industry and compete for international business with the giant Wall Street banks.

Sounds like a trade problem, doesn’t it? Germany’s already accused of being mercantilist. What better than to have a national lender, vested in facilitating those exports.

Problematic companies don’t have to be *owned* by the government. Just implicitly *backed* by the government. (Aren’t we guilty? After all, [TARP](https://www.investopedia.com/terms/t/troubled-asset-relief-program-tarp.asp). Yes, we’re guilty. [TBTF](https://www.investopedia.com/terms/t/too-big-to-fail.asp).)

**What’s in the SOE Chapter?**

Let’s start with what’s in [the SOE chapter](https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/22_State-Owned_Enterprises.pdf). It applies most expressly to SOEs that are majority-owned by the government. (Article 22.1) Of course, many companies are controlled by a principal shareholder that owns less than 51% of the company. The USMCA recognizes this problem and includes a provision that applies in circumstances where there is some sort of *de facto* control.

But as a legal matter, that is more difficult to prove than whether a particular ownership threshold has been met. A more ambitious chapter would have included a lower ownership requirement.

The disciplines on SOEs themselves essentially revolve around non-discrimination requirements. SOEs, when engaged in commercial activities, must not discriminate in favor of their own nationals. (Article 22.4) The chapter also has specific disciplines on the conduct of designated monopolies, including non-discrimination *and* a prohibition on anticompetitive practices that negatively affect trade or investment between the parties. (22.4.2(d))

There are also provisions disciplining governments from providing non-commercial assistance. (Article 22.6) These include loans to uncreditworthy SOEs, bailouts without restructuring plans, and debt-to-equity conversions that wouldn’t occur in the private sector.

(As a technical matter, the language in Article 22.7.1(c) is actually harmful. It adapts language in the WTO Subsidies Agreement. Likely with a view toward improving it, it actually makes it *harder* to prove price suppression or depression. Under the Subsidies Agreement, price suppression can occur without regard to whether the goods have been traded across borders. That is the basis for the U.S. claim against China in the aluminum dispute, where overcapacity depresses the global price, even though China does not export primary aluminum.)

**Why Just the Public Sector?**

The substantive rules make sense. They address unfair competition. But why are they limited to public sector anticompetitive behavior? Does it matter whether the entity receiving non-commercial loans is an SOE or a national champion? Is anticompetitive behavior by designated monopolies only a problem when it’s perpetrated by designated monopolies, rather than non-designated monopolies? Back to the bank bailouts - there are carve-outs for financial crises and other economic emergencies (Article 22.13)

The problem is not state ownership. The problem is anticompetitive behavior.

Yes, there is a [competition chapter](https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/21_Competition_Policy.pdf). But it does not include the types of rules, or the detail, we see here.

**The Downside of having an SOE Chapter**

This might all be much ado about nothing – what harm is there in having an SOE chapter, even if it isn’t as useful as people would like to think?

One problem is the implicit assumption that state control of the economy is acceptable, and the only issue that has to be addressed is state ownership of companies. But that’s inconsistent with the foundations of the multilateral trading system.  The GATT does not have detailed rules on state trading because after Stalin refused to join the talks, the very premise of GATT was to excludethe Soviet model.  China was allowed to join the WTO because it was supposed to become a market economy.  If we're going to change course, we must do so consciously, not by cobbling together chapters in trade agreements without adequate debate.

The real threat comes from government control, not government ownership.

China's authoritarian government, size, and anticompetitive intent are more problematic than the ownership structure of the companies in question.  The government can fund them, without having them be profitable, as long as it likes.  And it can control them without owning them.  As to intent, China actually invoked predation to try to get its companies out of antitrust liability in the United States (that's right - [by admitting its predatory intent, China persuaded a court to decline jurisdiction](http://americanphoenixpllc.com/trade-policy-china-hint-not-just-trade" \t "_blank)).  These factors have informed the current Administration's desire to frustrate Made in China 2025 -- even if they’ve [missed opportunities](http://americanphoenixpllc.com/questions-nafta-2-0s-auto-rules-china) to address it.

So if the premise of the SOE chapter is that it will rein in the likes of China, think again.  It might be useful with a country like India, which is adopting state capitalist strategies without the authoritarianism.  But even without state ownership, China will control its economy - and ours.

Now, some will say "but we can't let the perfect be the enemy of the good. We have to start somewhere!"  Fair enough.  If you feel that way, you should be thrilled with the new [sunset clause](http://americanphoenixpllc.com/nafta-2-0-sunsets).  It provides an impetus for us to reconsider rules that have proven not to be up to snuff, instead of having inadequate rules fossilized in perpetuity.

**The Mirror**

While millennials [contemplate democratic socialism](https://thehill.com/homenews/campaign/409877-poll-nearly-half-of-millennial-democrats-identify-as-socialist-or) as an alternative economic model, the calls to save capitalism from itself increase – even in the pages of the [Financial Times](https://www.ft.com/content/24552cfc-5c89-11e9-9dde-7aedca0a081a?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft:notification:daily-email:content). But trade agreements lag behind. They principally exist to [facilitate capitalism](https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/14_Investment.pdf), without providing adequate constraints on it.

But undisciplined capital flows also facilitate contagion, as [the financial crisis amply showed us](http://reinhartandrogoff.com/). The financial crisis also showed us what happens when governments are too deferential to financiers. The financial illuminati told us they didn’t need to be regulated because they don’t like losing money – but even *after* the crisis one of them lost (at least) [$9 billion](https://www.forbes.com/sites/steveschaefer/2012/06/28/jpmorgans-london-whale-losses-may-hit-9b-impact-earnings-and-capital-return/#4755b4a5307b) by [blowing through not only regulations but its own internal controls](https://dealbreaker.com/2013/03/senate-subcommittee-feasting-on-whale-today).

The Chinese ramped up state capitalism after the financial crisis. Is it possible they saw the crisis as a reflection of U.S. “free enterprise” and said *no thank you*?

If we don’t fundamentally change course, we will end up with a trade policy that continues to prioritize liberalizing capital flows while implicitly endorsing state capitalism. Financiers will continue to run amok in the West, and the Chinese government will continue to run amok in the East. What happens when they collide?

If steel and aluminum are any indication, state capitalism will prevail.

An SOE chapter won’t change that.