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International Investment by State Controlled Enterprises: A Source for Concern?

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Main message

The international business activities of state controlled enterprises appear to differ from those of otherwise comparable private-sector firms giving rise to issues that provide a basis for corrective policy actions.

Key Points

Rapid growth in international investment by state controlled enterprises (SCEs), particularly Chinese SCEs, has raised considerable public disquiet and policy challenges in a number of host countries. Examination of the issues associated with Chinese SCEs reveals grounds for policy concern with regard to transparency and accountability, the pursuit of non-commercial goals and the deployment of artificially created competitive advantages resulting from government subsidisation, preferential treatment, and structural distortions. In light of these concerns we discuss possible policy responses at the level of the home country, the host economy, and through international regulation.

JEL Classification codes L32; F23

Introduction

Patterns of international investment have experienced marked changes in the past decade (UNCTAD 2013). Two notable trends are the increasing role that new investment sources, particularly emerging markets play in terms of outward FDI (OFDI), as well as changes in the forms of international investment, most notably the rise of Sovereign Wealth Funds (SWFs) and international state-owned enterprises (SOEs). Much of this investment, both in new forms and from non-traditional sources, has targeted developed economies. For a number of potential recipient nations such investment raises novel issues and, in some cases, has triggered amendments to international investment policy. Of course there is a strong correlation between these two factors. Emerging markets, particularly the large BRIC countries, enjoy strong trade balances and rents from valued resources which have provided the foundation for major sovereign wealth funds. The China Investment Corporation (CIC) established in 2007 with assets of some US$200 billion from accumulated trade reserves has seen asset values double in the past five years. In addition, the particular institutional landscapes of these emerging markets are characterised by significant state involvement, both through direct ownership, political affiliation, and directive policy. The result is a growing importance of state controlled enterprises in international business. We can define state controlled enterprises as legal entities created by a government charged with undertaking commercial activities on behalf of the owner government.

The concerns created by state controlled enterprises in a number of host economies are based on the belief that SCEs may pursue objectives other than simply commercial success, that they enjoy competitive advantages denied to private firms, and that they could be a vehicle for the transfer of competing values and ideology (Meunier et. al. 2012).

The intention of this paper is to explore these concerns and to investigate the conviction that international investment by SCEs warrants special treatment and targeted policy responses, from potential host economies. This is achieved through an examination of the growing significance of SCEs in the global economy, an analysis of sources of competitive advantage enjoyed by SCEs, and a discussion of the policy options for addressing the challenges created by SCEs. Because of the significant role that Chinese SCEs play in international investment, we focus on this specific source of investment. The final section offers concluding thoughts.

The Significance of State Controlled Enterprises in International Business

Over the past decade the significance of state controlled enterprises (SCEs) in international business has increased and the development of both SWFs and SOEs has been strongly associated with the rise of emerging markets as international investors.

Sovereign Wealth Funds

Sovereign wealth funds are government investment vehicles that are typically created by the accumulation of foreign exchange reserves (China, Singapore) or returns to resources such as oil (Kuwait, Russian Federation). They are managed independently of a country's monetary reserves and monetary authorities. Their objectives are the creation of future income flows through professional portfolio management.

There are some 73 SWFs based in 46 countries. The assets held by SWFs have grown rapidly, doubling in value over the period 2000-2010. SWF assets were about $0.5 trillion in 2003, reached $3 trillion by 2007 and currently exceed $7 trillion (Truman 2010; The CityUK 2015). While SWFs have shifted from passive to more active investors, particularly before the onset of the global financial crisis, they are still marginal players in foreign direct investment (FDI). Their share of assets in FDI is low with outward FDI stock of around $100 billion, just 0.5 percent of the stock of world FDI in 2010 (Sauvant and Strauss 2012). SWFs have become involved in more cross-border mergers and acquisitions: while they were responsible for just one deal in 1987, this increased to 30 in 2007.

State-Owned Enterprises

Despite several decades of widespread economic deregulation and privatisation, state-ownership remains significant in many countries, both developed and developing economies. Indeed, the number of state owned multinational enterprises increased by almost a third between 2010 and 2012 reaching 845. Their combined FDI outflows accounted for 11 percent of global FDI in 2012 (UNCTAD 2013). The share of such FDI from developing economies has increased as these firms seek strategic assets such as technology and brand names.
Table 1 provides an indication of the extent of state control within the OECD group of countries.

Table 1 Here

Table 1 shows that levels of state involvement and control of business is relatively low within the established OECD economies and is somewhat higher within the emerging OECD group. The United States which displays a strong ideological preference for private ownership and minimal control of business has by far the lowest levels of state involvement. This is in sharp contrast to the situation in Russia where state interference remains pervasive. The table suppresses considerable differences between nation states. For example, in Finland the assets of SOEs were equivalent to 80 percent of GDP, while levels of 25 percent were observed in France and Italy and around 20 percent in Korea and Turkey in the mid-2000s (OECD 2005).

More detailed information on patterns of state ownership of business in the large BRIC emerging markets is provided in Table 2.

Table 2 shows that state ownership is comparatively high within the emerging BRIC economies, certainly much higher than levels within the OECD (Table 1). While there is some variation between the BRIC economies, SOEs characterised by a large government ownership stake are a key feature of the Chinese economy (Musacchio and Lazzarini 2012).

Table 2 Here

In comparison with SWFs, state-owned enterprises are much more significant international investors. UNCTAD lists more than 650 SOEs that control multinational operations (UNCTAD 2011). Of the 200 largest non-financial MNEs, 49 are SOEs with assets of $1.8 trillion. More than half (29 of 49) are based in emerging markets. In 2010 some 11 percent of global FDI flows were accounted for by SOEs and they account for 6 percent of the total global FDI stock (UNCTAD 2011). They operate in a range of industrial sectors. With the growth of international investment from emerging markets, China has now become the world's third largest investor after the United States and Japan (UNCTAD 2013).
We may expect the number of international SOEs to grow in the future, particularly as they are the primary vehicle for internationalisation in a number of large emerging economies including China and Russia, countries that are playing an increasingly significant role in total FDI (Sauvant and Strauss 2012). More than half of all SOEs are found in developing and transition economies and the BRIC economies in particular are major sources with Brazil

accounting for 1.4 percent of the total number of SOEs worldwide, Russia, 2.1 percent , India 3.1 percent, and China 7.7 percent. Between 2003 and 2010 outward FDI by SOEs accounted for one third of all outflows from developing and transition economies (UNCTAD 2011).

The Competitive Position of SCEs

The growth of state controlled international investment has generated considerable disquiet in a wide range of host economies. Table 3 provides a brief overview of the types of concerns that have been expressed about both SWFs and SOEs.

Table 3 Here

Table 3 highlights a number of concerns that host country governments and commentators have expressed regarding both SWFs and SOEs. From the table it is apparent that some concerns, for example, the negative influence of home country characteristics, a lack of accountability and transparency, and the possible pursuit of non-commercial objectives, are common to both types of SCE. However, it is also clear that other concerns exist that are unique to the particular type of SCE, whether SWF or SOE. Furthermore, these concerns stem from a variety of sources and could be classified as institutional, structural, strategic or distortionary. We discuss these concerns in more detail.

The first concern, and a shared one, is that SCEs are shaped by the characteristics of their home environments and that undesirable features of the home country are presumed to be transferred through the investment process. There is certainly evidence that international businesses are, at least in part, a product of their home environment (Nachum 2003; Porter 1990; Zheng and Tan 2011). The key traits identified in emerging and transition economies are underdeveloped market institutions, poor human rights records, and low environmental standards. Host country concerns highlight the likely structural and behavioural differences of investors based in non-market economies. Because of incomplete markets or underdeveloped institutions such firms develop distinct structures (multi-product and conglomerate forms (Khanna and Yafeh 2007) and place greater reliance on government links and support (Khanna et. al 2005). This is seen as likely to be distortionary in a developed market economy. The poor human rights records of some emerging markets, both within the

workplace and society in general, with poor public accountability, a repressed media and lack of political democracy, are seen as alien and undesirable values. Because of presumed close ties to their home country governments, international investments by SCEs are assumed to embody source country values and objectives to a greater extent than might be expected within private firms. Of course there is no inevitability that such values are reproduced, particularly when investment motives (market, resource, asset seeking) are diverse. For example, it would be reasonable to expect market-seeking investors to be more responsive to local (host) market conditions if they are to be successful and less likely to emphasise home country values. The reverse might be true of resource seeking firms, particularly those charged with strengthening home country security of supply. At the very least the investing firm is bound by local (host) country laws, regulations and standards.

A second shared concern is an apparent lack of transparency and accountability by SCEs. Of particular concern has been the limited information that is provided by SWFs and some SOEs. Analysis of these concerns suggests a number of principles that SCEs should adhere to, focusing on providing greater insights into issues such as the investors policy objectives and investment strategies, links between the government and managers of the investing entity, as well as greater transparency on investment strategies and outcomes. Measures of SWF transparency, both the Lunaburg-Maduall index and the Truman rankings show considerable variation between funds in terms of disclosure (Truman 2007).

A third concern regarding SCEs is the likelihood that they enjoy economies of scale as well as an ability to hold stakes in overseas ventures for the long-run. Where individual or institutional investors might move funds frequently in response to changing returns and opportunities, SCEs may benefit from state involvement by having access to lower cost funds or from being able to hold unprofitable positions where returns are not demanded in the short term.

Fourth, and one of the most widely discussed concerns, is that SCEs may pursue objectives other than wealth maximisation. Their links to national governments create the possibility that they may act as agents of the state pursuing political and strategic ends. It is difficult to conceive of such deviation in practice where SWFs are charged with maintaining or increasing wealth and SOEs are required to act as 'national champions'. A single instance of such behaviour being proved would destroy most, if not all, of a company's international

equity. The Chinese telecom giant Huawei offers an interesting example of a company that has been accused of close links with the Chinese state, denied access to broadband contracts in Australia, and thwarted in its attempts to acquire US high-tech companies, but which has not had to address any genuine evidence of wrongdoing (Economist 2012).

In the case of SWFs there are a number of other areas which generate concern in recipient nations. One is the fear that SWFs could gain control of critical assets or infrastructure. The attempted acquisition of Auckland International Airport by the Canada Pension Plan Investment Board in 2008 led to a widespread debate within New Zealand as to what constituted a strategic asset. A related concern is that SWFs might target newly privatised businesses. The fear here is that SWFs as controlling investors may lack the technical, managerial and industrial experience to successfully manage the assets. In such a case the (potential) gains from privatisation might be lost. Again, it is hard to imagine a SWF taking a controlling stake in a particular enterprise if it lacked the necessary capability or could not contract in the relevant skills. More likely is a scenario where a SWF takes a sizeable but minority position, and puts indirect pressure on management to the detriment of performance.

Other features of SWFs worth noting are their marked geographical and sectoral composition. Almost three-quarters of SWF investment is in developed countries, principally the UK, US and Germany, with the majority found in the services sector (UNCTAD 2008). Such concentration could create the perception that these funds were more sizeable than they actually are.

SWFs are also seen as potentially unstable. They are acutely sensitive to changing economic conditions which can impact on both their source (trade surpluses or high commodity prices) as well as returns. A number of SWFs suffered sharp falls in the value of their assets as a result of the global financial crisis (UNCTAD 2010). Finally, where SWFs operate under conditions of weak governance, such as Papua New Guinea or Vietnam, there is a possibility that they could be mismanaged reducing wealth (Truman 2011). At the same time attitudes towards SWFs seem to be sensitive to overall economic conditions and a number of potential host countries appear to have become more receptive towards such investment immediately after the global economic crisis (Fotak and Megginson 2009).

When we turn to SOEs, as well as the shared concerns, there are other distinctive issues. A widely aired concern is that SOEs are in essence instruments of government policy and as such, may be required to pursue non-commercial goals. A number of governments use their SOEs to gain access to critical supplies of natural resources such as oil or minerals. Others foster the development of internationally competitive enterprises through some form of industrial policy. In such cases favoured SOEs are often the vehicles for global expansion. This has certainly been the case with China's Go Global policy (Luo et.al. 2010; Peng et. al. 2008). In other cases home country governments may facilitate the overseas entry of their SOEs by linking aid and development assistance to project approval. These government to government relationships work to reduce political risk and transactions costs, increasing the attractiveness of investment into high risk activities and locations. The rapidly changing nature of Chinese outward foreign direct investment may reflect the likelihood that it is, at least to some degree, driven by political and strategic considerations. Chinese resource-seeking shows discernible waves, in part because of rejections, from North America and Australia and increasingly towards parts of Africa and Latin America (Scissors 2011). The spike in Chinese investment into land and food production following the world food price rises of 2008 (Anseeuw et. al. 2012) would also appear to be politically prompted.

There is increasing research support for a second concern regarding SOE investors - that they may not be representative of the larger pool of all firms (both private and state-owned). This concern is part of a wider set of issues that build on the idea that SOEs enjoy competitive advantages stemming solely from their ownership status. Recent work suggests that such concerns may have an empirical foundation and may be quite subtle in their operation. Wang et. al. (2012) report evidence that internationalising SOEs from China are more likely to possess stronger marketing and technological resources as well as capabilities, than purely domestic SOEs. These firms would appear to be in a much stronger position to succeed in overseas markets and to achieve government objectives such as technology acquisition and transfer as well as in overcoming marketing challenges. This research also suggests that it is state involvement and not simply state ownership that drives this selection bias. Firms that were state affiliated also benefitted when internationalising (Wang et. al. 2012).

There is considerable disquiet regarding not simply selection bias which results from state ownership, but a pervasive concern that the state may contribute to many of the apparent

competitive advantages that SOEs enjoy. This is the basis for the argument for 'competitive neutrality' within the public sector (OECD 2009). Competitive neutrality can be defined as the creation of a legal and regulatory environment designed to ensure that all enterprises - public and private - are subject to the same rules and regulations and that government affiliation does not confer unjustified advantages.

However, governments face strong incentives to ensure that their SOEs succeed, both domestically and internationally. This bias occurs despite the more general role of that of the state as a regulator of business activity. While government created privileges contribute to the creation of competitive advantages in the home country, many of these same advantages can be deployed in international markets, mirroring the significance of internationally transferable firm-specific advantages in explaining international operations (Dunning 1988).

State support of SOE competitiveness operates both directly and indirectly. It can persist despite the trend towards subjecting SOEs to greater market discipline and accountability through mandating commercial returns and increased corporatisation. The basis of concerns in this area is the fact that generally the resulting competitive advantages do not reflect underlying efficiencies, rather they are artificial and welfare reducing.

Directly, the state can impact on SOE competitiveness in a number of ways. First, SOEs can enjoy significant subsidisation through the provision of concessionary financing. Where funds are provided to SOEs from other state controlled financial organisations the terms of such funding may be subsidised with capital costs held below market rates, generous write off of interest charges, as well as the provision of state guarantees which effectively lower borrowing costs. Differential bankruptcy rules may be used to enable SOEs to carry losses for a significant period, effectively extending their planning horizons when compared with private businesses.

Second, other forms of subsidisation may be enjoyed by SOEs including direct subsidies to sustain operations as well as exemptions from certain taxes or business regulations. Other benefits include favourable provision of resources such as land and critical infrastructure. All forms of subsidisation artificially lower the operating costs of SOEs enabling them to price more competitively than less favoured rivals.

Third, preferential treatment by governments may also benefit SOEs. Such treatment might include the provision to SOEs of commercially valuable information, particularly on overseas market opportunities, favoured status in public procurement processes, and exemption from anti-trust legislation.

Fourth, SOEs may also benefit from an exclusive or monopoly position, particularly important in activities characterised by extensive economies of scale. They may be sheltered from full competitive pressure when foreign investors or import competing products are restricted. Even where competition exists, incumbency advantages of SOEs can be used to impose less favourable entry conditions on potential competitors. Such advantages increase the relative competitiveness of favoured firms.

Governments can also contribute to the creation of SOE competitive advantage indirectly. Generally, such effects operate through business structure and incentive systems. The structural distortion most evident with SOEs is the issue of captive equity. Because equity within an SOE is effectively locked in government hands, transfer of ownership and control of an SOE is much lower than that of an otherwise comparable private firm. The absence of a takeover threat reduces the incentive for SOE management to operate at optimal efficiency since they face few effective sanctions. They may engage in anti-competitive behaviour with little fear of declining stock values or pressure for management change. SOEs may also be absolved from making commercial returns and dividend payments if they are empowered to pursue other (non-commercial) objectives. Where SOEs are not subject to market discipline they may face soft budget constraints which could provide a rationale for pursuing aggressive growth or internationalisation. In such cases we might observe greater intensity of outward FDI or earlier internationalisation of SOEs than would be seen in otherwise comparable private firms. We might also observe a willingness to overpay for acquired assets. Incumbent SOE managers may enjoy high levels of freedom when they face little pressure on their positions. In some cases the government owners will display a preference for internal promotion or the transfer of staff from other branches of the public sector. Mechanisms for changes in management are attenuated by a so-called 'third agency problem' which arises because the public, the ultimate owners of SOEs, can only vote for change indirectly through national elections which may be less than transparent in some cases.

Further indirect competitive distortions could arise when SOEs are used as elements of industrial or development policy. In a number of emerging markets - particularly China, Russia and Brazil - SOEs are used to foster certain types of economic activity such as critical capabilities or the development of key technologies which are interpreted as being in the broader national interest. This type of activity is embodied in proactive industrial policy, a framework for government funded or supported initiatives designed to promote economic growth and development, an approach widely adopted in economies such as Taiwan and South Korea (Amsden 2001; Wade 1990). In the development context such policy and role for SOEs can be justified as an attempt to correct for market failure where private agents are unable or unwilling to fund such activities. State intervention may be seen as necessary to capture externalities and to signal new opportunities to the market.

For a number of developed economies state ownership may find favour as a way of preserving and protecting national competitors in what may be termed critical, strategic or national interest industries. Government interventionism in France, particularly since around 2002, has seen attempts to restructure nationally strategic industries such as pharmaceuticals, protect individual firms like Danone, and even keep car manufacturing jobs in the home country.

The Challenges of Chinese State Controlled Enterprises

Chinese state controlled enterprises are of particular interest for a number of reasons. On the one hand they display many of the general characteristics that are associated with all SCEs; on the other hand, they also reveal distinct and challenging aspects.

One distinctive aspect is the rapid rate of international growth of China's international investment. China's FDI has grown strongly since 2006, in part as a result of government encouragement, with the stock doubling between 2009 and 2012. China's outward FDI flows increased five-fold between 2006 and 2014, reaching $116bn, while the stock reached $730bn, a nine-fold increase since 2006 (UNCTAD 2015). Since more than 80 percent of China's overseas investment is undertaken by SOEs (Morck et. al 2008), the growth has been remarkable. Strong growth is also expected to continue with any slowing in the domestic economy increasing the attractiveness of international investment. Indeed, China is expected

to reverse its current situation to become a net exporter of capital (OFDI exceeding IFDI) in the next few years.

The timing of China's rapid internationalisation has also raised concerns. At the time of the Global Financial Crisis, Chinese firms with high levels of liquidity enjoyed opportunities to pick up distressed assets from cash strapped businesses. In the past five years Chinese firms have been active in acquiring assets in banking, insurance, mining and property, including New York's Cassa Hotel. This type of investment, despite the fact that it brings much needed capital to distressed firms, has fuelled resentment in a number of potential host economies.

A third area of concern with Chinese investment relates to their strategic behaviour. As late entrants and relatively inexperienced investors, their decision making is not always consistent with host country expectations (Wong 2012). In a number of cases Chinese firms have seemingly over-paid for assets, although this might be welcomed by host country sellers. In other cases they have appeared extremely naive in their practices. In the case of Chinalco's failed bid for Australia's Rio Tinto, the Chinese firm failed to understand the perceived strategic importance of Rio Tinto within Australia, and subsequent opposition (Yao et. al. 2010). Similarly, CNMC withdrew its bid for Lynas Rare Earth when it realised it would not be granted a majority board position. The Chinese state-owned Minmetals bid for OZ Minerals was never going to be allowed when one acknowledges the proximity of the company's main mine to Australia's weapons testing centre at Woomera. Similar shortcomings are apparent in other Chinese investments in mining where investors failed to realise that responsibility for major infrastructure was that of the mine operator and not the local government. At the same time many Chinese investors have struggled to accept the well-established expectation that engineering, construction, procurement and management work in the mining sector is awarded to local contractors. Such misunderstandings cause both confusion and difficulty in estimating likely investment returns.

The preference for mergers and acquisitions characteristic of much Chinese overseas investment is a further source of contention. The perception in many host economies is that such investments in existing assets contribute much less than greenfield (or new) investment. For this reason there are likely to be higher levels of opposition, or more demanding tests of acceptance, for such ventures. These concerns are heightened when investors target what are regarded as 'strategic' industries. Definitions of what constitute 'strategic' assets vary between

countries and over time, but often encompass energy and power, telecommunications, banking and rare minerals.

Concerns are also expressed over the distinct characteristics and advantages enjoyed by Chinese state-controlled firms. These include their concentration in what are widely regarded as globally strategic sectors (defence, petroleum, telecommunications, aviation, automobiles and shipping), their opaque governance structures, ongoing and pervasive government support and subsidisation as well as their ability to make massive investments in public relations and meeting net benefit tests in host economies. Because regulators may find it difficult to separate Chinese SOEs from the Chinese state, such investors may be hampered by their connections to the state (Cui and Jiang 2012), the massive power advantage that China enjoys over many potential host countries (Duanmu 2014) and perceived asymmetry in market access. For example, while Chinese investors are able to purchase agricultural land in New Zealand, New Zealand firms are denied the same opportunities in China. Related concerns regarding reciprocity have been expressed in Canada (Dobson 2014).

Policy Responses to International Investment by State Controlled Enterprises

We have argued that international investment by state-controlled enterprises, particularly those from emerging economies such as China, has become both more significant in recent years and is likely to increase in the near future. For this reason it is imperative that host country governments ensure appropriate policy responses to what many see as novel and challenging forms of FDI. We can usefully distinguish between three sets of policy responses: one focusing at the home country level; one at the international level; and a third grounded in the host country. However, it is also important to recognise that there is a school of thought that argues that such investors do not raise any novel regulatory challenges and should not be treated any differently to other international investors (Globerman and Shapiro 2009; Globerman 2015).

This position is based on a view that market pressures force state-owned enterprises to behave in ways that mirror private enterprises precluding the pursuit of non-commercial or political objectives. While it is accepted that SOEs may impose costs (negative externalities) that might result from their labour or environmental practices or lack of transparency, it is

assumed that these can be addressed by existing regulatory policies in most host economies. This view, of course, assumes the efficient operation of market forces, bestows a high level of capability on national regulatory bodies, and discounts secondary spillover effects. There is some indirect evidence to suggest that the strategic choices of SOEs do differ from those of private firms. For example, one study found that SCEs were more likely to invest in economies with a poor rule of law or high level of corruption, perhaps because of a moral hazard problem which leads the managers of such firms to believe that the state will be more willing to assist them in the face of difficulties (Knutsen et.al. 2011).

Home Country Policies

It may appear unusual to suggest that policy responses to FDI should focus on the home countries of investors. However, as we discussed above, it is here that the distinctive characteristics of these investment forms are forged, so it follows that they can also be changed. In effect, if SCEs can be subjected to reforms in their source country they may be seen as less novel and challenging to investment regulators and policy makers in the host country.

A number of useful home country policy reforms can be identified (Musacchio and Lazzarini 2012). The first would be further privatisation. Renewed privatisation could push SCEs closer to the profile of private sector investors reducing their idiosyncrasies. There are likely to be several constraints on such moves. In many of the important SCE emerging home economies such as Russia and China, there is strong ideological commitment to state involvement and hence, reluctance to reducing such involvement. Similarly, there is evidence that even after a programme of privatisation some state influence is likely to remain. A study of OECD countries pursuing privatisation after 2000 found governments retained some degree of control over almost two-thirds of their privatised businesses (Bortolloti and Faccio 2009).

A second strategy would be to rely on home country regulation to ensure that SCEs operate as efficiently and effectively as possible, ideally at a level similar to that of otherwise comparable private firms. The heart of such policy would be competition regulation. Providing a competitive environment matched with appropriate incentives could alter SCE behaviour. Unfortunately, there are significant policy challenges when regulating SCEs. One is the likelihood of general competition policy conflicting with sectoral regulation and

protection. As highlighted earlier, SCEs are frequently found in strategic sectors and may enjoy special treatment. Generic competition policy is founded on the belief that firms are pursuing the goal of profit maximisation. This may not be the case for SCEs charged with social goals such as income redistribution or employment creation. Effective competition policy is also constrained by the difficulty of obtaining information on the operations of SCEs. They may not be required to match the accounting and disclosure standards of private sector firms when information disclosure is geared towards public expenditure management rather than sound corporate governance. The complexity of many SCEs, being multi-product or industry, can create difficulties when practices such as cross-subsidisation occur. Furthermore, the imposition of competition policy to ensure neutrality may not be justified in all cases. During the recent global financial crisis a number of government have felt that the social welfare benefits of bailing out banks and leading businesses have outweighed the advantages of adhering to strict competitive neutrality. Such crisis situations may attenuate the case for the strict enforcement of competition policy.

A third home country response would be to improve the standards of disclosure and transparency of SCEs. The fundamental changes would focus on disclosure of the non-commercial objectives that SCEs are charged with as well as the forms and levels of any subsidisation they enjoy. In addition, home country governments need to carefully delineate their role as stakeholders in state controlled enterprises from their regulatory and policy roles affecting the performance of such firms. Disclosure and transparency also benefit from consistent incentive systems and adherence to high standards of commercial decision making, shielded, where possible, from political interference.

A fourth strategy would be to move the management and decision-making processes of SCEs away from the perception of a traditional public sector model. Ways to achieve this include ensuring an open and competitive market in the recruitment of managers into SCEs as well as the appointment of independent and accountable directors to SCE boards.

Fifth, there are also significant opportunities for increasing the acceptance of SCEs as international investors through the reform of corporate governance. Widely discussed reforms in this area include the separation of commercial and non-commercial objectives of SCEs and a continuing assurance that they face all normal business costs. Other changes would, again, mimic structures and processes characteristic of private firms. The increased use of

professional managers employed under conditions that permit bonus payments or promotions based on performance and merit could change behaviour radically. Such performance-contingent contracts are now widely adopted in Chinese SOEs (Bai and Xu 2005; Mengistae and Xu 2004). Public listing of SCEs perhaps through the sale of minority state shareholdings would increase information disclosure through the prospectus process and enable greater monitoring of performance by external minority investors. It may also be useful to implement legal changes that protect the interests of minority shareholders particularly where a SCE pursues multiple goals. However, the trade-offs in this area appear far from simple (Pargendler 2012).

China represents perhaps the most comprehensive attempt to reform its SOE sector in an attempt to change the behaviour of its firms. Liang et. al. (2015) highlight two principal forms of institutional environment in China's development: administrative and market-oriented. Administrative institutions emphasise political connections and suggest a close alliance between SOE management and state interests. In contrast, market oriented institutions focus on ownership arrangements and the development of pecuniary incentives consistent with international and private sector experience (Peng 2003). Reforms have focused on deregulation of input prices, particularly interest rates, increased competition from non-state firms, and raising dividend payments. Property rights have been much more clearly defined while SOE governance arrangements have become more consistent with international practices including the appointment of independent directors and greater consistency in the selection of directors (Megginson and Netter 2001). Recent analysis shows that Chinese SOEs have changed their globalisation strategies in light of the reforms suggesting that Chinese SOEs show greater convergence with private sector MNEs after the reforms (Liang et. al. 2015; Ralston et.al. 2006).

It is worth noting that source country reforms should not simply be considered in isolation. There are likely to be important interactions between them. For example, sound corporate governance complements effective privatisation since it enhances the commercial value of businesses increasing their attractiveness in the market.

International Regulation

Proposals for the international regulation of SCEs have focused primarily on SWFs, chiefly because of their novelty to many host economies. In 2008 a set of principles known as the Santiago Principles were released by the International Working Group of Sovereign Wealth Funds under the auspices of the IMF. The Group offered a set of 24 principles and practices within a voluntary framework subject to home country laws and regulations. Their focus, not surprisingly, was on the very concerns that host governments had expressed - issues such as appropriate governance and accountability, desirable investment practices, and improved information transparency.

At the same time the OECD has been working to strengthen principles for foreign investment from a wide range of organisations, but again with a focus on SWFs. The principles highlighted include those that have long been applied to all forms of foreign investment - non-discrimination, transparency, investment barriers, disclosure of investment decisions, and regulatory proportionality in the face of national security issues (OECD 2008) .

The OECD position is, in essence, that existing investment instruments provide the fundamental assurance that any international investor - private, state-owned or SWF - requires. The principles of fair treatment of foreign investors based on non-discrimination, transparency of investment restrictions, liberalisation of capital movements and legitimate national security concerns, provide a predictable and manageable environment irrespective of the particular form of the investor. In other words, the issues that SWF and SOE investment creates can be accommodated under existing investment instruments. The underlying principle is to ensure adherence to these regulations within an open investment environment that has been put under considerable strain from both the global financial crisis and the rise of non-traditional international investors.

The OECD is anxious to avoid investment measures aimed at SCE investors because they could have a negative impact on private investors when investment laws do not sufficiently distinguish between the two groups of international investor.

While initiatives in this area by the OECD are to be welcomed they carry some obvious limitations. First, such regimes are non-binding and are subject to appropriate implementation by national governments. The likelihood of achieving binding regulations is low. Second, concerns with globalisation and changing patterns of competitive advantage mean that

commitment to capital liberalisation is not as strong as it was in the 1990s. The growth of protectionist policies and the promotion of national security and strategic interests means that enforcement of guidelines is unlikely to be pervasive (Enderwick 2011). Third, the OECD as a grouping has obvious geographical limitations and does not directly encompass the BRIC economies, a major source of concern with regard to SCE international investment.

Host Country Policies

Host country policies to deal with the challenges of SCEs are of particular interest because it is here that most of the anxiety and opposition the such investments has been generated. We can usefully classify host country responses into four main areas: tackling public opposition; improving the competitive operating environment; the imposition of specific requirements; and regulatory amendments.

Tackling Public Opposition

In many host economies there is an absence of well founded debate on the benefits and challenges of international investment from non-traditional investors. This creates a void which may be filled by political or media invective, much of it highly critical. Campaigns based on improving the quality of public debate, developing a public relations campaign to highlight potential benefits, or emphasising mixed models of control could be useful in attenuating public opposition. An interesting example is provided in the case of Brazil which is plays an increasingly significant role in international investment as both a home and host nation. The Brazilian Development Bank (BNDES) was charged with not only managing Brazil's comprehensive privatisation programme but also took a minority stake in a number of companies (Musacchio and Lazzarini 2012) enabling the creation of mixed enterprises, with elements of private, state and foreign ownership, and reducing concerns that newly privatised assets would simply fall into foreign hands (De Paula et.al. 2002).

Improving the Competitive Operating Environment

A second host country policy response to non-traditional investment would be to accept the entry of SCEs but to attempt to create an operating environment that forces such firms to behave in ways expected of purely private firms and which minimises the distortionary

competitive advantages SCEs might possess. Central to such a policy would be maximising competitive pressure through the elimination of exclusive rights, the minimisation of licenses and other authorisations, opening up public procurement to all firms and easing entry of new competitors. Such a policy would tolerate international investment by SCEs but attempt to neutralise any non-efficiency based competitive advantages enjoyed by such firms. In a highly global economy pressure to change the behaviour of dominant SCEs could come from a variety of sources. An interesting example is provided by the Russian state-owned gas monopoly Gazprom which has seen its dominant market position challenged as other producers such as the United States develop countervailing advantage through shale gas production.

The Imposition of Specific Conditions

A third, and increasingly utilised policy stance, has been to approve international investment by non-traditional investors, but to link approval to a number of specific conditions that must be met. Such a policy is based on the view that these types of investment are somehow different, and while not requiring a separate regulatory regime or process, do raise novel challenges. There have been a number of recent cases, albeit not always involving SCEs, which illustrate the length to which some host governments will go to. In a recent New Zealand case approval was given to a Chinese buyer to acquire a significant parcel of dairy land. Approval was conditional on the company meeting some 27 additional conditions including the provision of scholarships, the creation of an on-farm training school, investment in heritage sites and for the principals to be of continuing good character (Enderwick and Nagar 2012). In a second case, the acquisition of a sizeable Australian cotton farm by a Chinese company, the purchaser was required to sell down their stake to 51 percent within three years, to engage in arm's length trading of any cotton, and for the property to be operated and managed by the Australian company using the existing workforce. More bizarrely, when Australian mining giant BHP attempted to acquire Canada's PotashCorp, the company offered a number of conditions including a willingness to forego tax benefits, to remain a member of the Canpotex potash export consortium for five years, and even establish its global headquarters in Canada (Walker 2012).

Regulatory Amendments

A fourth response adopted by a number of countries has been prompted by a belief that existing regulations do not provide adequate security for SCEs and their growth means that new or amended regulations are required. A number of countries including the United States, Germany, Russia and Australia have followed this route (Truman 2010). We briefly consider two examples.

The United States foreign investment review process based on its interagency Committee on Foreign Investments in the United States (CIFUS) was amended in 2007 through the Foreign Investment and National Security Act (FINSA) to strengthen approval processes and to place greater weight on national security concerns. A key feature of the legislative change was to toughen CIFUS examination of transactions involving SCE investors. The change also empowered CIFUS to impose and enforce any conditions necessary to mitigate national security concerns. The legislative change has been viewed positively in one important sense - by strengthening the review process it helps reduce the political uncertainty that surrounds international transactions. While there has been an increase in the number of cases considered under the FINSA changes from 2009, there is little evidence to suggest that it is impeding foreign investment into the United States.

Germany also amended its foreign investment review processes in 2009 to allow the Federal Ministry to review foreign investments and provided powers to suspend or prohibit transactions (involving 25 percent or more of voting rights) that threaten national security or public order. The legislation does not explicitly distinguish between private and public investors. The new powers appear to have been applied carefully and between April 2009 and December 2011 no foreign acquisitions of a German company were suspended or prohibited (Jost 2012).

Conclusions

In this paper we have considered policy responses to the challenge of FDI by state controlled enterprises, with a particular focus on Chinese firms. The rapid internationalisation of such

firms appears to be creating regulatory challenges for a number of host economies. The issue is also of critical importance to Chinese policy makers who place considerable reliance on China's large SOEs to achieve ambitious internationalisation targets.

Our discussion suggests a number of conclusions. First, we have argued the there has been strong growth in international investment by SCEs and that these non-traditional investors create novel issues for host country investment approval agencies. All the available evidence seems to support the view that SCEs are playing an increasingly important role in international business and anecdotal evidence shows widespread public disquiet with this type of investment.

Second, our discussion offers considerable support to the view that SCE investors do create novel policy challenges. Of particular concern are poor levels of transparency and accountability and the pursuit of non-commercial goals. In the case of SOEs, in the absence of pervasive competitive neutrality, there is evidence that SOEs may enjoy non-efficiency based competitive advantages generated through subsidisation, preferential treatment and structural distortions. Home governments, directly or indirectly, are responsible for these competitive distortions.

Third, because these challenges are real in many cases, policy responses may be desirable. We suggest that these may occur within the home country (altering SCE behaviour to bring them closer to the model of private firms), at the international level, and most controversially, within targeted host countries. Reforms at these different levels are likely to be complementary. However, the picture is complicated by the dynamic nature of institutional reform within emerging economies such as China. Over time, it appears that the strategies of Chinese SOEs for example, are likely to show greater convergence with private sector practices.

Fourth, our discussion reveals some limitations of current work and suggests several fruitful research paths. We have given little consideration to other, generally protectionist, policy responses such as France's decision to designate a number of industry sectors as strategic and hence closed to foreign investors. Similarly, other potential host nations have created 'golden shares' that give existing holders the power to veto foreign investment, or the creation of so-called 'white knights' - state supported investment funds that hold available equity in key

firms and sectors to prevent foreign acquisition. These responses are worthy of more detailed examination.

Even modest regulatory revisions could be useful in bringing policy clarity. Current foreign investment policy regimes are based on ownership while it is company behaviour which is critical in determining the impacts of FDI. A shift in policy focus, coupled with greater corporate transparency, would be valuable. Such a shift would place greater demands on the capability of regulators who would need to develop an enhanced understanding of economic and business conditions in source economies. Similarly, recent research insights need to be incorporated into policy decision making. For example, Liang et. al. (2015) find that while the state is a major influence on the selection of which SOEs are permitted to internationalise, their impact on the degree of globalisation of such firms is more limited. Similarly, Cui and Jiang (2012) provide evidence that SOEs face stronger pressures of isomorphism to adapt to host country norms. Recent work suggests that strong institutional pressures faced by SCEs may result in them pursuing few acquisitions and accepting lower levels of control, than often assumed (Meyer et. al. 2014).

In addition, in a number of economies the protectionist focus has been on particular classes of assets (strategic, security sensitive or those meeting national interest criteria) as opposed to targeting the type of investor (private, state owned or state affiliated). Understanding this policy preference would be useful in appreciating the dangers of global protectionism.

Finally, our analysis has emphasised majority state ownership, characteristic of most SWFs and many SOEs. However, it would be useful to extent the analysis to consider the richer concept of 'varieties of state capitalism' where international investors enjoy a range of benefits stemming from state affiliation and not simply state ownership (Musacchio and Lazzarini 2012; Wang et. al. 2012).

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