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Host country concerns and policies toward state-owned MNEs[*]

by
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Governments provide fiscal and financial incentives to attract FDI. But when state-owned enterprises (SOEs)[1] are the investors, attitudes reverse, and governments tend to constrain their investments. Host country officials distrust foreign SOEs' motives and perceive them as recipients of unfair state support in the form of preferential financing, subsidies and tax concessions. Such perceptions do not always match reality, however. Some governments maintain hands-off relationships with their SOEs, while many large private companies benefit from government support. Nevertheless, perceptions remain, and host country governments end up treating foreign SOEs differently, imposing additional regulatory procedures, limitations on public procurement, investment restrictions, and controls on cross-border transactions.

In many cases, governments claim national security as justification for discriminating against SOEs. Discrimination contravenes international investment agreements, but it is often allowed for national security reasons. However, such justification tends to be overused and masks a variety of issues that require different policies. Three concerns, in particular, may require different policy responses, and the appropriate policies are those that are defined ex-ante and narrowly to address these specific concerns.

The first and typical concern over foreign SOEs is national security. Whereas privately held companies are founded by entrepreneurs to take advantage of market opportunities, SOEs tend to be created by governments to solve market imperfections and achieve goals that the private sector is not addressing. Hence, FDI by SOEs may be perceived as an extraterritorial tool and raise concerns about their non-business objectives. Such apprehensions are likely to be particularly prevalent in areas that are considered sensitive to national security in the host country, i.e., areas that are crucial for ensuring military superiority in case of conflict.

The identification of areas of national security concern and the exclusion of all FDI may be the appropriate policy. Ex-ante policies that clarify which sectors are important for national security, and do so narrowly, would help establish clear rules for all investors. A narrow definition of national security areas, such as defense and advanced dual-use technologies, helps avoid domestic companies using the national security argument to limit foreign competition. Exclusion may apply to all foreign companies and not only state-owned ones. SOEs are directly connected to their home country governments, but private companies can also be influenced.

A second issue is opacity. SOEs suffer from a multilevel agency problem; citizens are nominally the owners of companies, but politicians have control, and politically-appointed managers run the companies. This may result in politicians directing investments abroad to politically-beneficial areas even if these investments have limited business value. This complex multilevel agency problem affects how state-owned MNEs are perceived to behave abroad, creating concerns about the opacity in their decision-making because it is not fully clear who is responsible for decisions.

Monitoring is an adequate policy, and one that does not require special treatment for foreign SOEs. Both domestic and foreign companies can follow the domestic practices of disclosure of organizational structures and responsibilities. If current laws and regulations are not up to par, host country governments can update them and apply them to all companies to increase transparency and accountability in actions.

A final issue relates to adversarial governments. As the old saying goes, governments do not have friends, they only have interests. They can exercise influence and build and deploy soft power through SOEs, directing companies to support the development of friendly countries even if it is not profitable to do so. However, in some cases, home and host country governments may have an antagonistic relationship, and host country governments may want to avoid influence or punish home country governments.

Control may be an adequate policy. Perceptions of divergent interests are unclear, they can change quickly with the rotation of governments in home and host countries, and international investment agreements limit discrimination. Identifying ex-ante the criteria politicians use to judge other governments and their diverging interests, and establishing judicious and sparingly-used review and control mechanisms concerning FDI from countries with adversarial governments, may help reduce misunderstandings and potential retaliation and an escalation of animosity.

In conclusion, investments by foreign SOEs raise multiple concerns that require clarification. Justifications based on worries loosely related to national security tend to be overused for excluding SOEs’ investments and may mask concerns over opacity or adversarial governments. The exclusion of SOEs is not the only policy alternative. Monitoring and control mechanisms are available and may be more appropriate. Policies that clarify host country governments' views on an ex-ante basis and that have a narrow scope are useful. They help balance the benefits of FDI while addressing politically important concerns over SOEs' behavior, prevent domestic companies' regulatory capture by seeking protection from foreign competition in the name of national interests and help SOEs plan investments with a higher likelihood of success.

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[1] State ownership of firms is very diverse. See, Alvaro Cuervo-Cazurra et al., "Governments as owners: state-owned multinational companies," *Journal of International Business Studies*, vol. 45 (2014), pp. 919-942.