Fighting Fire with Fire: Employing Regulation Against Government

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ŽILVINAS
ŠILĖNAS

After the dissolution of communism in Eastern Europe, most state-held property was transferred to private ownership. That effectively ended the ownership of means of production by the state and destroyed the foundations on which communism stood. While privatization varied in time and scope in different countries, the basic idea was to never return to state-owned bakeries, petrol stations, or restaurants.

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While some companies remained state-owned, in the spirit of privatization, it seemed just a matter of time until all state-owned enterprises (SOEs) were private. Remaining holdouts (energy companies, railways, and other "strategic assets") it was thought by some, would be privatized later. That in fact was the agenda of some governments for at least a couple decades.

However, the political climate changed and the enthusiasm for privatization died down. The 2008 financial crisis, geopolitical tensions, and other macro factors have slowed down SOE privatization. In some CEE countries, the trend has even reversed. Estonia nationalized its railways in 2007 and Lithuania bought out private investors in its energy companies. Far from being on a transition to privatization, it seems that SOEs are here to stay for a long time.

This puts free marketeers in a peculiar position. Our best solution is, of course, to privatize SOEs. But if privatization is out of the political agenda, what is the second-best solution? Make SOEs adhere to the same set of rules as private companies, lose the privileges they have, or be run like private businesses?

STATE-OWNED ENTERPRISES – A RECURRING HEADACHE

The fundamental problem is that the state retains ownership of the means of production – just like in the Soviet times. However, some more dangerous problems loom when the state retains ownership of large companies. Lost revenue, industry politicization, handing out well-paying jobs to party loyalists, sub-optimal pricing, cross subsidization – all are a reason for concern.

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It is equally dangerous if SOEs go on the offensive to expand their operations. First, it is not unfathomable that during the times of uncertainty SOEs can be better-placed to invest or expand into new sectors of economy compared to private investors. Bureaucratic burdens, taxation, and regulation all create large obstacles for private businesses. But SOEs can easily bear them or avoid them. When government creates rules and must abide by them, it is not unusual for governments to change the rules so SOEs can proceed. It is called "corruption" if such favors are handed to private companies, but "public interest" if SOEs are involved.

IF SOEs ARE HERE TO STAY, WE NEED SOME SORT OF REGULATORY RESPONSE THAT LIMITS THEIR EXPANSION AND MITIGATES THE DAMAGE THEY CAUSE

Second, we should not forget that rich SOEs could attract high-quality people or outcompete private sector for talent. Capable managers tasked with increasing the value of SOEs see no qualms in expanding SOE operations. Pair talent with deep pockets and flexible rules, and SOEs can truly push private companies out of the market.

If SOEs are here to stay, we need some sort of regulatory response that limits their expansion and mitigates the damage they cause. But we also need a *casus belli* to show that expanding SOEs are a problem, one that can be tackled with regulation.

Of course, free marketeers have an abundance of arguments against SOEs *per se*. However, in the changing political climate, they would not suffice. Liberal arguments and evidence are very powerful for people who subscribe to or sympathize with liberal ideology. But if a new political consensus sees no problem with the government owning the means of production, those arguments would not do.

So, let us re-explore the notion of government failure and regulatory capture. After all, if governments justify intervention into markets because markets are imperfect, could we not adopt similar arguments in relation to SOEs? If regulatory capture is possible (and even the critics of liberalism agree that it is), would SOEs not be guilty of that as well? Would it not be something that governments should address?

REGULATORY CAPTURE, GOVERNMENT FAILURE

Because the government is the agency that sets up and enforces regulations, it has the ability to create an uneven regulatory playing field. As critics of capitalism like to point out, it can happen even without the involvement (or existence) of SOEs. Private enterprises are also susceptible to engaging in regulatory capture, attempts to subvert regulation to favor certain enterprises or business models.

If private companies engage in regulatory capture, there remains a possibility for it to be discovered and dismantled. Since non-neutral regulations favoring certain private enterprises produce losers and winners, the losers have the incentive to expose capture and show how certain companies profit from it. If regulation is exposed and recognized as unfairly benefiting certain private actors, there is a large chance that this will be recognized as "unfair" and regulatory capture – dismantled.

IF CERTAIN SECTORS OF THE ECONOMY HAVE BEEN DOMINATED BY THE STATE, IT IS LIKELY THAT PROFESSIONALS, RESEARCHERS, OR EVEN ACADEMICS ARE CONNECTED TO THE SOEs

But if we have a situation where SOEs are involved, and especially where SOEs receive preferential treatment vis-à-vis private ones, the chances of undoing the regulatory capture are reduced.

First, the public and the politicians might not even recognize the existence of capture. Preferential treatment to SOEs might be explained as a natural feature arising from regulating a complex sector of the economy, where absolutely equal treatment is technically impossible.

If we accept that regulatory failure arises because industry players can hire better talent than the regulators, this certainly works in the case of SOEs. In fact, if SOEs are not experiencing pressure from shareholders to produce profit (which is often the case), they can afford to spend more resources on hiring the best talent to argue with regulators and influence politicians and decision-makers.

Even more, if SOEs dominate or have been dominating a certain sector of the economy (e.g., energy), smaller countries might lack talent for the regulators to hire. If certain sectors of the economy have been dominated by the state, it is likely that professionals, researchers, or even academics are connected to the SOEs. They do not need to be working for the SOE or benefiting from it in any way. But due to the long-term dominance of the sector by SOEs, professionals and academia might come to believe that SOEs *are* the proper way to run the sector. That is especially prevalent in sectors that have a degree of technological sophistication or where very few people have had direct experience in the sector. To rephrase Hayek, there is a true "knowledge problem" here: few people know how to run a sector, and those who do believe that the government should run it.

Second, even if regulatory capture is recognized and it is acknowledged that an SOE is receiving preferential treatment, many politicians or regulators might not

Example 1. Independent producers of energy in district heating system in Lithuania

A large portion of houses in Lithuania are heated by a district heating system (DHS). After reforms in 1997, DHS was decoupled from the gas and electricity sectors. After the reform, each DH company produced energy and supplied it via district heating pipelines to consumers as a vertically integrated company. After 2003, the two activities were unbundled into energy production and energy supply. Supplying energy in DHS via pipelines remained a market with barely any competition. Most DHS supply networks remained municipality-owned; moreover, companies with DHS supply networks also retained energy production facilities (power plants) and remained vertically integrated companies.

However, energy production became a competitive market where different independent producers of energy could produce energy and sell it to the DH company to be delivered to consumers. To open up the market, a regulation was imposed that stated DH companies have to purchase energy produced by independent producers if the independent producer offers energy for a price smaller than the variable cost of energy production in the power plant of a vertically integrated DH company.

On one hand, the integrated DHS company is forced to purchase energy from its competitors. On the other hand, it has to purchase it only if the competitor is able to produce energy for less. The problem arises in how the rule is set up. If independent producers want their energy bought, they have to offer the price, which is not only lower than the energy production cost of the integrated DH company. Instead, the price charged by the independent producer has to be lower than the variable cost of the DHS company.

To put it simply, in order to stay in business, independent producers have to be so efficient that their fixed (capital) costs and variable (fuel) costs are lower than variable (fuel) costs of incumbent DHS companies. The playing field is uneven, yet this practice remains. Moreover, many decision-makers feel that this system is “as good as it gets” or even too generous to independent producers.

The discussions regarding this issue touches upon nearly all the possibilities mentioned in the article. Some decision-makers think this system is as fair as it could get due to the nature of the sector. Others believe that DHS supply companies have to have certain advantages because they are tasked with being a “supplier of last resort”. Yet others think that liberalization and opening of the market was a mistake, and hope that this regulation will drive independent private producers out of the market, making the DHS entirely owned and operated by the government.

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see it as an issue. Under the guise that SOEs are there for purposes other than profit, the necessity to apply the same rules to all enterprises might not be evident. It is not unheard of to apply one set of rules to “for-profit” companies and another set of rules to “not-for-profit” companies. The tendency does not even have to be stated explicitly to have implicit consequences for the thought processes of politicians, regulators, journalists, or even judges.

To put it simply, SOEs are very capable of convincing decision makers that they are in business not to earn profit, but for some “higher purpose”. Therefore, preferential treatment vis-à-vis private enterprises (which, of course, are in the “for-profit” business and nothing else) is natural, unavoidable, and justifiable (some politicians and regulators might not even need convincing, since this is exactly what they believe in anyway).

Third, even if cases where regulatory capture is identified and recognized as a problem, regulators and politicians might still choose to continue the practice [See Example 1]. Quite often, SOEs are tasked with many politically motivated functions (e.g., to provide very cheap transportation services). SOEs can convince poiticians that giving preferential treatment to SOEs vis-a-vis private enterprises is natural, unavoidable, and justifiable. And, of course, some politicians and regulators might not even need convincing, since this is exactly what they believe in anyway [See Example 1].

THE IDEAL SOLUTION TO PREVENT SOEs FROM EXPANDING WOULD BE TO PERSUADE THEIR SHAREHOLDERS (THE GOVERNMENT) ABOUT THE DANGERS OF EXPANSION AND HAVE THE SOEs DISMANTLED AND PRIVATIZED

ENTRANCE

PUBLIC
ENTRANCE
GPO

Example 2. A questionnaire to help assess whether new regulation has an impact on competition

Does regulation affect market entry *directly*? There is a high probability that it does, if the regulation:

- Grants special or exclusive right to a company;
- Orders to purchase a product from a single company or a set group of companies;
- Creates a new licensing procedure or any other mandatory procedure that is necessary for companies to start operation;
- Fixes or caps the number of market participants.

Does regulation affect market entry *indirectly*? There is a high probability that it does, if the regulation significantly increases:

- Market entry costs for companies trying to enter the market;
- Market exit costs for companies trying to enter the market.

Would the new regulation affect the *abilities* of companies to compete? It is likely if regulation:

- Limits whether companies can decide on prices for their own products;
- Sets arbitrary requirement for products; or
- Increases the costs of some companies operating in the market;
- Limits method of sale or place of sale; or
- Limits advertising of products.

Would the new regulation affect the *incentives* of companies to compete? It is likely if regulation:

- Requires or encourages to publish information about costs, prices, volumes of sales, and production; or
- Exempts certain companies or sectors from observing rules of competition; or
- Increases costs for consumers who wish to select or switch suppliers; or
- Sets or changes the regime of intellectual property.

If you have answered NO to all questions, it is very unlikely that the proposed regulation would affect competition.

If you have answered YES to any single question, it is necessary to evaluate alternatives and select the one with least or no effect on competition

Source: Competition Council of Republic of Lithuania http://www.kt.gov.lt/uploads/documents/files/veiklos-sritys/viesieji-pirkimai/klausimynai/Kaip_vertinimo_klausimynas.pdf

If government chooses to regulate a sector of the economy, there is a risk that regulation will be captured and exploited to curb competition. If regulatory capture is done by SOEs, the risks are much higher. SOEs can be better positioned to perform capture, and politicians, regulators, and other agencies tasked with prevention of regulatory capture might choose not to act to prevent or dismantle the capture.

ARTICLE 4 OF THE LAW OF COMPETITIONS STATES THAT GOVERNMENT AGENCIES CANNOT ISSUE REGULATIONS THAT WOULD DISTORT COMPETITION, DISCRIMINATE, OR FAVOR CERTAIN ENTERPRISES VIS-À-VIS OTHER ENTERPRISES

HOW CAN SOE EXPANSION BE CURBED?

Obviously, the ideal solution to prevent SOEs from expanding would be to persuade their shareholders (the government) about the dangers of expansion and have the SOEs dismantled and privatized. As this explicit solution is not usually an option, we have to look for second-best, indirect solutions to the problem. Lithuania provides several interesting case studies.

1. Prohibit discrimination and even instead of neven

Article 4 of the Law of Competitions states that government agencies cannot issue regulations that would distort competition, discriminate, or favor certain enterprises vis-à-vis other enterprises. Therefore, ministries, municipalities, and other government agencies are prohibited from favoring any enterprises, including SOEs. To put it simply, if the government created a government-run taxi company and ordered all public-sector departments to purchase taxi services only from this company, such a regulation would be a direct violation of Article 4 and void.

Of course, Article 4 has its limits. It cannot cancel laws passed by the Parliament. Continuing the taxi company example, if Parliament passed a law which stipulated the creation of said company and obliged public-sector department to purchase taxi services only from this company, Article 4 would be powerless. However, if that were the case, one could invoke Article 46 of the Republic of Lithuania, which stipulates that the economy of Lithuania is based on private property and monopolizing a market is prohibited.

Therefore, Article 4 serves to prevent ministries, regulatory agencies, and local governments from creating an uneven playing field. The article cannot prevent it if the

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government is intent on distorting the market and has the political influence to pass the law in Parliament. However, it constitutes a rapid response option (especially compared to the Constitutional Court). If it were not for this regulation, many public agencies would get away with violations simply because the court system is slow and cases can drag on for years.

The Competition Council of Lithuania is also engaged in prevention work. Their questionnaire [See Example 2] is designed to help decision-makers quickly evaluate whether their proposed regulations or rules would affect competition. Moreover, it encourages selecting alternatives with the least impact on competition.

Article 4 has been invoked multiple times. It serves as a preventative measure to dissuade politicians from passing bad legislation, and as a tool to cancel regulations that have been passed. And yes, it has been used to dismantle a government-run taxi company in 2014 [See Example 2].

2. Prohibit purchases without open tenders

A new amendment to the law on public procurement forbade SOEs from contracting their subsidiary companies without an open public tender. That means that SOEs cannot purchase goods or services from companies they own without an open public auction in which independent contractors are also allowed to participate. Furthermore, if an independent contractor offers a lower price (or a better value), SOEs are obliged to award the contract to the independent contractor, not their own subsidiary. However, municipality-owned enterprises are exempt from this obligation.

How is this amendment helpful? First, some large SOEs have a history of insourcing, rather than outsourcing, various services.

For example, the national railway carrier of Lithuania (Lithuanian Railways) manages infrastructure and runs freight and passenger services, and also has subsidiary companies for building and repairing railway tracks, servicing engines, providing security, cleaning, and environmental protection services, renting *road* cargo vehicles and agricultural machinery, planting trees, and selling firewood. If SOEs are allowed to purchase goods and services from their subsidiaries without open tender procedures, there is a risk that many of the subsidiaries are propped up by SOEs to continue operating sub-efficient businesses at the expense of the taxpayer and competition.

Second, many of the subsidiary services have nothing to do with the rationale given when governments chose to retain ownership in SOEs. To put it simply, one can understand (and disapprove) when the government claims to retain ownership of railways for "strategic" or "security" reasons. However, there is nothing "strategic" about a SOE owning a subsidiary that sells firewood. Speaking in terms of what is politically feasible, it might be difficult to persuade the government to privatize the railways. But it is much easier to convince the public and politicians that the government has no business running a company that sells firewood.

Third, this prohibition has a couple of potential positive outcomes. If non-essential subsidiaries are inefficient and have been propped up by a parent SOE, the requirement to go into open tenders could push them out of the market and into bankruptcy. That would then open possibilities of liquidating the companies, privatizing them, or closing them down. In one way or another, the objective of reducing direct participation of the government in the economy would be achieved.

If, on the other hand, the subsidiaries survive competition enabled by open tenders, it might result in lower prices and higher operating efficiency of a SOE. Transparency created by open tender procedures also create possibilities to inquire whether the subsidiary is playing on a level playing field in terms of regulation or whether it receives subsidies from the parent company. Regardless of how one looks at it, destroying the possibility for parent SOEs to purchase products from its subsidiary without any competition, publicity, and at inflated prices greatly reduces the ability for SOEs to finance subsidiaries in other sectors of the economy.

That type of regulation could be expanded as widely as possible, covering SOEs and also municipality-owned enterprises (MOEs) or even public bodies. If the law on public procurement applies to any agency spending taxpayers' money, there is a possibility to apply and extend this regulation.

Of course, one could argue that this is not a free-market solution, or that there is nothing inherently wrong with companies purchasing products from their subsidiaries at inflated prices. Or that private companies do it all the time. The critique is correct. However, given the realities of politics and the extent to which some SOEs abuse the system and the challenges posed, it might be a worthy policy choice.

3. Prohibit easy expansion into other sectors of the economy

If the previous part dealt with what to do with SOEs that have expanded into other sectors of the economy, this part will highlight a possible counter-measure to prevent expansion. As an old dictum goes, "prevention is better than cure".

IF, IN THE LONG RUN, THINGS TURN SOUR AND GOVERNMENTS CONTINUE THEIR MARCH INTO THE ECONOMY, WORKING ON LEGAL BARRIERS TO CURB THE GOVERNMENT IS A WORTHY AND TIMELY INVESTMENT

An amendment to the law of local governance passed in 2016 stated that if a local government (municipality) wanted to create government-owned companies (or expand existing ones), it had to prove to the Competition Council that establishing a new government-owned company was the only way to achieve the necessary public policy objectives. If a city decided to create a government-owned taxi company, it would have to prove that it had exhausted all other possibilities to provide public transportation.

Of course, this rule is not foolproof. However, it provides a legal barrier, a type of legislative roadblock to prevent fast developments. What is more, even if a municipality does provide its side of an argument for establishing a government-run business, in reality it is very difficult to actually prove that this is the only or the best way to achieve the policy objectives.

Currently, there are no cases addressed by this procedure, yet Parliament attempted to remove this rule from legislation. Even though it did not make it into the spring session of Parliament, it is very likely that the issue will be revisited in the fall session of 2017.

CONCLUSIONS

It seems that SOEs are here to stay. While we should not abandon plans to privatize them if favorable conditions arise, we have to start thinking how to limit their expansion in a world where liberalism and free market have lost some of their luster. Regulation, or more regulation, is anathema to free marketeers, but I fear that, currently, it is one of the few (if flimsy) options to contain the expansion of the government into the economy.

If things go our way in the end, and governments return to privatization, the regulation of SOEs will be seen as a temporary measure in uncertain times. If, in the long run, things turn sour and governments continue their march into the economy, working on legal barriers to curb the government is a worthy and timely investment. ●

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ŽILVINAS ŠILĖNAS

A member of the Lithuanian Free Market Institute (LFMI). A policy analyst in fields of energy and competition. He is also a member of the Lithuanian government commission for reducing administrative burden.