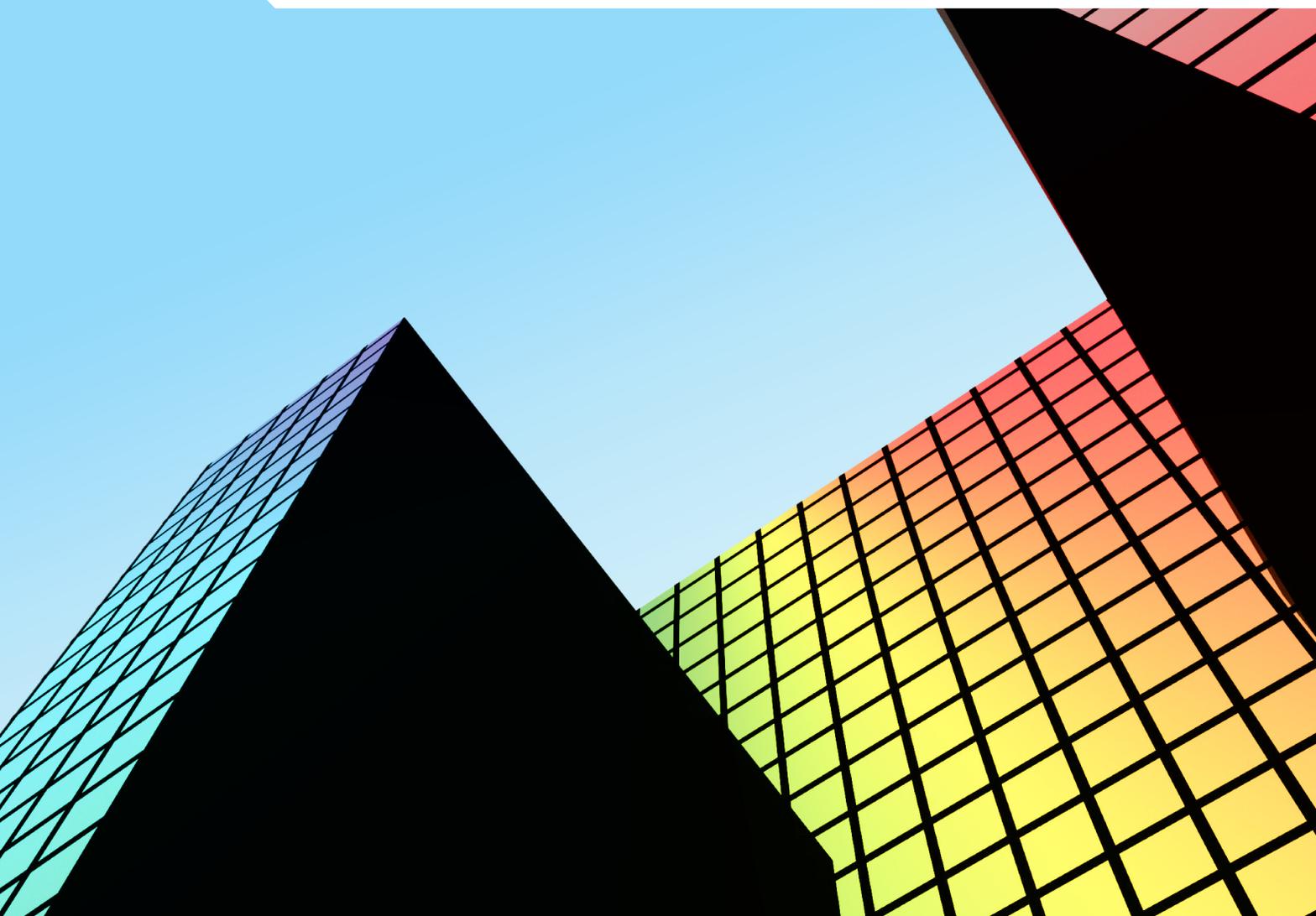




# Competitive Neutrality

**A COMPENDIUM OF OECD RECOMMENDATIONS,  
GUIDELINES AND BEST PRACTICES**



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## EXECUTIVE SUMMARY

This report recalls the eight priority areas that need to be addressed by national authorities committed to the principle of competitive neutrality (i.e. “a level playing field”) between public and private providers of goods and services. The purpose of the report is to provide a full picture of the existing OECD instruments, and related good practices and guidance, which may have implications for competitive neutrality. The report is structured according to the eight priority areas that were previously agreed by the Working Party on State Ownership and Privatisation Practices: the operational form of government business; cost identification; rate of return requirements; public service obligations; tax neutrality; debt neutrality; regulatory neutrality; and public procurement practices. The below summary provides an overview of the coverage and directions of the existing OECD sources in each of these fields. The findings are further synthesised in the table following the section.

***Streamlining the operational form of government businesses.*** An important aspect in addressing competitive neutrality is the degree of corporatisation of government business activities and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for the commercial activities to operate in a market-consistent way, but may not always be either feasible or economically efficient. Where individual enterprises are engaged in a combination of public policy objectives and more conventional business activities, questions often arise about the market-consistency of the business activities. The main OECD instruments, guidelines and best practices deal with the following aspects of these issues:

- To level the playing field in regulated sectors, OECD recommends structural measures, separating commercial and non-commercial activities, to the extent that benefits outweigh costs. These recommendations are applicable to SOEs as well as other incumbents which maintain market power. (Council Recommendation on Structural Separation, Recommendation on Competition Policy and Exempted or Regulated Sectors and Report on Regulatory Reform.)
- The SOE Guidelines recommend corporatising commercial and, if feasible, non-commercial units which operate on a commercial basis and in competitive, open markets to the greatest extent possible, among other reasons, to maximise transparency and accountability.

***Cost identification.*** Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. However, to achieve it depends on the level of incorporation of the business. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). If public service obligations are subsidised by the public purse, costs should be identified in a transparent manner to ensure neither over compensation nor under compensation. For unincorporated units of general government which share costs between commercial and non-commercial activities, the concern is that the attribution may often not be feasible. Existing OECD guidance and recommendations concerning this topic include the following:

- Best Practices in Budget Transparency recommend disclosing the proportion of shared costs and assets that are attributed to commercial activities, when non-commercial activities are not conducted separately.
- A number of guidelines propose that the degree of subsidies disbursed by the State should be made transparent (SOE Guidelines, Accountability and Transparency Guide and Guidelines for User Charging for Government Services). The first two of these address incorporated SOEs only; the latter address general government as a whole.
- Other guidelines recommend removing any cost advantages or disadvantages which may exist due to public ownership (Regulating Market Activities by the Public Sector, and Guidelines for Contracting Out Government Services), mostly with applicability to both SOEs and general government.

**Commercial rates of return.** Achieving a commercial rate of return is an important aspect in ensuring that government business activities are indeed operating like comparable businesses. If they do not have to earn returns at market consistent rates, private sector competition can be undercut, and even more so if SOEs pursue aggressive pricing policies. Furthermore, setting appropriate rates of return for each separate line of commercial activity is an important factor to ensure that SOEs are not engaging in cross-subsidisation. The main OECD guidance bearing on this topic is found in the following areas:

- According to OECD guidance, SOEs should earn rates of return equivalent to that of private sector businesses; and performance should be benchmarked with similar business activities in the same industry. (Regulating Market Activities by the Public Sector, Accountability and Transparency Guidelines, Predatory Pricing Reports.) The guidance is applicable to the commercial activities of general government and of incorporated SOEs.
- SOEs and other types of government businesses may be required to pursue objectives other than profit maximisation. OECD guidance holds that such objectives should be made transparent and should not be used to undercut actual or potential competition. (SOE Guidelines, Best Practice Guidelines for User Charging for Government Services.)
- While good practice acknowledges the role of traditional competition-law based approaches to anti-competitive practices (e.g. cost predation tests), it does recommend that other approaches may be more adequate if SOEs do not maximise profits or are allowed to earn lower rates of return (e.g. appropriate cost accounting mechanisms and comparing performance across industries). (Predatory Pricing, Accountability and Transparency Guidelines).

**Public service obligations.** A competitive neutrality concern invariably arises when the provision of public policy priorities are imposed on SOEs which also operate in the market place. The extent to which market arrangements are used will depend on the national context and what is truly representative of the public interest. Competitive neutrality requires an accurate costing, pricing and regulation of parts of the service provision which takes place on a commercial basis. This suggests removing privileged access that SOEs/incumbents may have and compensating the companies adequately. The main points emerging from the relevant OECD guidance and best practice bearing on accounting for public service obligations are:

- OECD guidance recommends a sufficient degree of transparency and disclosure surrounding the use of public budgets provided as compensation for fulfilling public service obligations.

The use of public resources should be subject to budget oversight and monitoring. (SOE Guidelines, Principles for Managing Ethics in the Public Service, Accountability and Transparency Guide, Market Mechanisms in Public Service Provision, Promoting Performance.)

- In the context of balancing commercial and non-commercial priorities, OECD guidance recommends that SOEs should receive adequate compensation for the public policy priorities they are asked to undertake. They further recommend that compensation is disbursed and spent in a manner which can be accounted for separately. (SOE Guidelines, Accountability and Transparency Guide, Best Practices for Budget Transparency, Best Practice Guidelines on Off-Budget and Tax Expenditures.) These recommendations are applicable to incorporated and, in most cases, unincorporated units of government.
- OECD guidance recommends establishing reliable cost calculation methodologies that avoid, to the extent possible, cross-subsidisation practices. (SOE Guidelines, Accountability and Transparency Guide, Report on Universal Service Obligations.) In a competitive neutrality context, this is relevant in cases where SOEs or incumbents are expected to provide essential public goods alongside commercial activities.

**Tax neutrality.** The equal tax treatment of public and private business activities is important for competitive neutrality. Where government businesses are incorporated along the lines suggested in the SOE Guidelines this is usually not an issue. However, careful consideration should be made in order to ensure government is not provided any perverse incentives to avoid paying taxes. For example, government should generally not favour purchasing goods and services from itself in order to avoid taxation. The following points emerge from OECD guidance that bears on tax neutrality:

- In cross-border trade, businesses in similar situations carrying out similar transactions should be subject to similar levels of value added taxation (OECD International VAT/GST Guidelines – International Guidelines on Neutrality). This is one of the relatively few relevant pieces of OECD guidance to deal specifically with the cross-border aspect of neutrality.
- In cross-border trade where specific administrative requirements of foreign businesses are deemed necessary, value added tax should be administered in a way which does not create disproportionate or inappropriate compliance costs for business (OECD International VAT/GST Guidelines – International Guidelines on Neutrality).
- In cases where tax rules cannot be evenly applied, OECD good practices recommend transparency surrounding such tax exemptions in order to determine and rectify possible advantages associated with them (Marketisation of Government Services).

**Regulatory neutrality.** Regulatory neutrality not only deals with the general business environment issues (i.e. business laws and regulations) it is also concerned with market regulations (i.e. sector specific). Concerning the general business environment, in most OECD economies, incorporated SOEs are subject to the same/similar regulatory treatment as private businesses. Where SOEs are created according to corporate charter or statutory authorisation, or where commercial activities remain integrated with general units of government, certain regulatory exemptions may be afforded by law which may not be consistent with competitive neutrality. OECD guidance covers the following issues concerning regulatory neutrality:

- Where regulatory exemptions apply due to the SOEs legal form, OECD Guidance recommend incorporating SOEs according to company law making it subject to the same regulatory treatment as private businesses. Where this is not possible, the validity of regulations could be extended to the SOE; or could be applied on a voluntary basis. (SOE Guidelines, Draft Recommendation of the Council on Regulatory Policy and Governance).
- OECD guidance recommends that government participation in regulated markets be evaluated on a periodic basis. Such recommendations are particularly relevant for regulated markets where SOEs or incumbents retain certain monopoly rights (Recommendation on Competition Policy and Exempted or Regulated Sectors, Recommendation on Improving Quality of Government Regulation, Report and Recommendations on Regulatory Reform, Guiding Principles on Regulatory Quality and Performance, Recommendation on Competition Assessment).
- Concerning financial regulation, OECD guidance on Effective and Efficient Financial Regulation recommends that regulations should be consistent and neutral irrespective of ownership, institution, sector, and markets. This applies equally to government-controlled or owned financial institutions.
- OECD guidance recommends that a combination of regulatory and non-regulatory measures may be necessary to neutralise any advantages or disadvantages that may accrue due to ownership. Competition, trade and investment authorities are all identified as having a role in enforcing competitive neutrality. (APEC-OECD Integrated Checklist on Regulatory Reform, OECD Guiding Principles on Regulatory Quality, Report and Recommendations on Regulatory Reform.)

***Debt neutrality and outright subsidies.*** The need to avoid concessionary financing of SOEs is commonly accepted since most policy makers recognise the importance of subjecting state-owned businesses to financial market disciplines. Competition and other regulatory authorities in EU and many other jurisdictions enforce competition law to rein in outright subsidies and state aids, and subject SOEs to market conditions in accessing finance. Despite such advances, debt neutrality remains an important area to tackle if the playing field is to be levelled. Many government businesses continue to benefit from preferential access to credit in the market due to their perceived government-backing. Existing OECD guidance and recommendations bearing on this topic take into account, among other things, the following:

- OECD Guidance recommends that public enterprises access credit on the same terms as the private sector (SOE Guidelines; Regulating Market Activities by the Public Sector, Competition and Financial Markets). This guidance is generally applicable to state-owned entities and state-owned banks as receivers of credit, but also to state-owned banks also as providers of credit.
- OECD good practices put into place mechanisms to account for debt neutrality adjustments, drawing upon a number of Member experiences, such as those of Australia and the EU (Regulating Market Activities by the Public Sector, Roundtable on Competition, State Aids and Subsidies).

***Public Procurement.*** To support competitive neutrality, procurement policies and procedures should be competitive, non-discriminatory and maintain high standards of transparency. However, some additional issues may arise. Where long-existing SOEs or in-house providers are involved, their incumbency advantages may be such that the entry of competitors is effectively impeded. To a certain

extent these advantages may be classified as traditional economies of scale that do not in principle contrast with competitive neutrality. However, if the authorities are intent on obtaining a truly competitive environment then they nevertheless have to be considered. The following points emerge from OECD guidance that bears on public procurement and competitive neutrality:

- The SOE Guidelines recommend that general procurement rules should apply to SOEs as they would apply to other companies.
- A number of OECD guidance have recommended transparency in procurement policies and procedures; in setting clear selection criteria in advance; and ensuring fair and equitable treatment in the selection of suppliers. Any unfair barriers are recommended to be removed to ensure fair and un-discriminatory selection processes. Where discriminatory preferences exist, OECD recommends that these should be made transparent in the selection criteria shared with potential bidders in advance (SOE Guidelines, OECD Recommendation for Enhancing Integrity in Public Procurement, Guidelines for Contracting out Government Services, Principles for Managing Ethics in the Public Sector). This guidance applies to SOEs as purchasers.
- The Best Practice Guidelines for Contracting out Government Services recommends that in-house bids should be treated the same as outside bids in terms, and neutrality should be safeguarded between private and public providers.
- OECD guidance stresses integrity and ethics as essential in the procurement process. (SOE Guidelines, OECD Recommendation for Enhancing Integrity in Public Procurement, Principles for Managing Ethics in the Public Sector, Effective Action Against Hard Core Cartels, Guidelines for Fighting Bid Rigging in Public Procurement.) This applies to SOEs as public purchasers and organisers of tenders. The Recommendation on Cartels also applies to state undertakings participating as suppliers themselves.



## Chapter 1

# INTRODUCTION TO COMPETITIVE NEUTRALITY AND STATE-OWNED ENTERPRISES

### 1.1. Background and context

Most policy-makers agree that competitive neutrality is a sound idea and member governments of the OECD have demonstrated their commitment to a level playing field. This commitment has been voiced at the ministerial level on a number of occasions. In the 2010 *Communiqué of the Public Governance Committee at Ministerial Level* Ministers acknowledged: “Building on past experience, the OECD should provide guidance on strengthening integrity safeguarding the public interest, and levelling the playing field for the private sector”.<sup>1</sup> Most recently on the occasion of the Commemoration of the 50th Anniversary of the OECD during the 2011 Meeting of the Council at Ministerial Level, the Chair remarked, “As the OECD enhances its engagement with emerging economies, it must also continue its groundbreaking work to develop multidisciplinary guidelines for the treatment of state-owned and state-controlled enterprises...whether they are owned by shareholders or states, all companies should operate on a level playing field consistent with the principles of competitive neutrality”.<sup>2</sup>

In specific national contexts, governments of a growing number of countries have decided to enshrine the principle of competitive neutrality in legislation; this has been the case in Australia and in a number of EU countries, where in some cases regulatory bodies have been empowered to enforce it. National practices demonstrate the applicability of such principles and are an important resource for identifying good practices which can inspire the development of principles on competitive neutrality. This topic has been the subject of a number of reports published by the Secretariat, notably through the Working Party on State Ownership and Privatisation Practices (WP SOPP) and the Competition Committee;<sup>3</sup> it has also been the subject of other instruments or public pronouncements, mostly addressing other issues, but containing provisions of possible relevance to competitive neutrality. These are reflected in an extensive body of knowledge that is either internal to the Organisation or published in an informal fashion which covers a broad range of disciplines including public management, taxation, finance, trade, and investment. The paper draws from all of these to reflect a current OECD shared position concerning competitive neutrality.

The report synthesises existing OECD instruments, good practices and related guidance that bear on the topic. It is organised into eight sections according to the relevant priority areas identified by the WP SOPP (Box 1.1). The issues covered in this paper may be applicable to the activities of unincorporated public businesses, ring-fenced public businesses, actual state-owned enterprises, state or other public institutions, and in some cases to recently privatised companies which maintain incumbency advantages. Important issues may also arise from the commercial activities of the non-profit (or “third”) sector, but they fall outside the scope of the questionnaire and report.

### Box 1.1. Priority areas identified for this paper

The organising principles for this paper are based around eight priority areas which deserve specific attention as they can be considered the key determinants of competitive neutrality:

- *Streamlining the operational form of government business.* It is easier to pursue neutrality when competitive activities are carried out in an entity with an independent identity, operated at arm's length from general government. To achieve this governments can incorporate government businesses according to best practices (i.e. the OECD Guidelines on Corporate Governance of State-Owned Enterprises) or to structurally separate commercial from non-commercial activities. This could also be useful in countering ad-hoc political interventions that might impede competitive neutrality.
- *Identifying the direct costs of any given function.* Where commercial activities are carried out by unincorporated entities a main challenge is that these often share assets with the other parts of the government sector – especially if the costs of these assets are joint costs. Developing appropriate cost-allocation mechanisms is then important to ensuring competitive neutrality.
- *Achieving a commercial rate of return.* Competitive neutrality implies that government businesses pay a market-consistent rate of return (ROR) on the assets they use for providing the relevant activities. A market-consistent ROR would be one that is comparable with what is earned by similar firms within the same industry. The importance for competitive neutrality derives from that fact that, if government businesses were not required to earn a commercial ROR then they would be able to undercut competition by factoring lower profit margins into their pricing.
- *Accounting for public service obligations.* One of the most challenging issues for competitive neutrality arises where SOEs that operate in a competitive environment are required to carry out non-commercial activities in the public interest. Companies should be adequately and transparently compensated through the public purse in a way that avoids market distortions. If SOEs are under- or over-compensated for public service obligations then the playing field becomes tilted.
- *Tax neutrality.* Tax neutrality implies that government businesses bear a similar burden as their private sector competitors. The implementation usually differs markedly according to whether or not government businesses are incorporated or operated by government offices. Actual SOEs generally face direct and indirect tax requirements that are similar to those of any other enterprises. Conversely, government activities are often not subject to indirect taxes, and it would be in many cases legally impossible to impose corporate taxation on the earnings of units of general government.
- *Regulatory neutrality.* To maintain competitive neutrality government businesses should operate, to the largest extent feasible, in the same regulatory environment as private enterprises. In some countries public businesses have been reported to have quicker access to planning and building permits (not least where municipally owned businesses are concerned) and a lighter regulatory approach to government-controlled financial sector activities. Unincorporated public sector business activities may also benefit from easier pension liabilities than their private competitors.
- *Debt neutrality and outright subsidies.* Debt neutrality implies that SOEs and other government businesses shall pay the same interest rate on the debt obligations they incur as a private enterprise in like circumstances. It is straightforward for governments to ensure that SOEs and government businesses do not benefit from outright subsidies or subsidised finance. However, additional problems may arise when government-backed businesses, because of a perceived lower default risk, obtain cheaper finance in the market place than would be available to private operators.
- *Public procurement.* The basic criteria for public procurement practices to support competitive neutrality are that they be competitive and non-discriminatory, and that all public entities participating in a bidding process should operate according to standards of competitive neutrality. However, where long-existing SOEs or in-house bids are involved their incumbency advantages or other advantages may be such that the entry of competitors is effectively impeded.

Each section provides a) a brief introduction to the priority area and its relevance to competitive neutrality; b) an overview of and excerpts from *OECD instruments* bearing on the topic; c) an overview of and excerpts from relevant *good practices and guidance* bearing on the topic; and d) conclusions highlighting the relevance of existing OECD sources – and, by implication, identifying areas for potential future development. OECD instruments adopted by the OECD Council as either binding or non-binding commitments are presented in the form of international norms and standards, best practices, and policy guidelines and principles. In this paper OECD Instruments are presented separately, since owing to their legal status they hold greater weight in national policies and usually imply implementation. Other good practices and guidance are usually approved by their respective policy communities (via committees or their subsidiaries) and are often considered best international practices.<sup>4</sup>

This report, along with a separate questionnaire-based report entitled, *National Practices Concerning Competitive Neutrality* serve as building blocks for a best practice report on competitive neutrality. The reports have also been subject to a comprehensive consultation involving non-OECD countries, sub-national levels of government, the business community and other consultation partners. They serve as building blocks to a best practice report entitled, *Competitive Neutrality: Maintaining a level playing field between public and private business*.

## **1.2. Competitive neutrality and objectives**

In most OECD countries many public sector entities provide goods and services in competition with the private sector – or in areas where private sector businesses could potentially compete. Insofar as markets are open and there is a level playing field among the public sector and private providers – which is both healthy and economically efficient – this is said to be competitively neutral. However, the experience of OECD countries illustrates that several sources of competitive distortions can arise because of advantages or disadvantages some public sector commercially-oriented activities face by virtue of their ownership. Governments may create an uneven-playing field in markets where state-owned enterprises (SOE) compete with private firms, as they have a vested (direct or indirect) interest in ensuring that state-owned firms succeed. Often this interest is not only driven by commercial considerations but is also due to non-commercial priorities such as maintaining public service obligations, promoting national champions through industrial policy, protecting fiscal revenue derived from SOEs, correcting market failures and other politically sensitive issues such as safeguarding the political influence of ministries and protecting public sector jobs.

Competitive neutrality occurs where no entity operating in an economic market is subject to undue competitive advantages or disadvantages. In the current context the ownership issue is limited to the state and is applied to the activities of all types of government-owned bodies that are actually or potentially competing with private operators in any market (i.e. either state or municipal agencies, state or municipal enterprises, or state/municipally owned corporations); it may also bear on the competitive position of entities that may not be directly controlled by the government but which benefit from state aid in exchange for the fulfilment of services of general interest (e.g. licensed operators, legacy rights or recently privatised companies). Important issues may also arise from the commercial activities of the non-profit (or “third”) sector, but are outside the scope of this report.

*A priori*, the most relevant instrument for this report is the Guidelines on Corporate Governance of State-Owned Enterprises (the “SOE Guidelines”).<sup>5</sup> The SOE Guidelines’ Chapter I directly recommends “a level playing field” in activities where SOEs and private enterprises compete. That said, the Guidelines are primarily oriented toward incorporated SOEs (i.e. separate from the public administration) owned by central government and having largely commercial orientation (i.e. with the bulk of their income coming from sales and fees), whether or not they pursue a public policy objective

as well. Furthermore, the Guidelines do not detail how to obtain a level playing field in practice. Where governments' involvement in business activities is not conducted through corporate vehicles (or where local or regional authorities are the driving force) other recommendations beyond the SOE Guidelines may be needed. Moreover, to provide more detail on how to obtain competitive neutrality in practice, any guidance in principle is welcome.

## Notes

1. [www.oecd.org/dataoecd/1/50/47231930.pdf](http://www.oecd.org/dataoecd/1/50/47231930.pdf)
2. [www.state.gov/secretary/rm/2011/05/164280.htm](http://www.state.gov/secretary/rm/2011/05/164280.htm)
3. See OECD (2009), "State Owned Enterprises and the Principle of Competitive Neutrality", *Competition Committee Policy Roundtable*, [www.oecd.org/competition/roundtables](http://www.oecd.org/competition/roundtables). Also see OECD (2011), "Competitive Neutrality in the Presence of State Owned Enterprises: Practices in Selected OECD Countries".
4. For more on OECD Instruments see:  
[www.oecd.org/document/46/0,3746,en\\_21571361\\_38481278\\_40899182\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/46/0,3746,en_21571361_38481278_40899182_1_1_1_1,00.html).

Also see database of all OECD Decisions, Recommendations and Other Instruments in force:  
<http://webnet.oecd.org/oecdacts/>

In some cases, existing recommendations, guidance, and best practices may not be directly transferable or applicable to SOEs and/or other government activity that can be considered "commercial" in nature. OECD sources should be considered with a "grain of salt" in that applicability to a competitive neutrality context may not have been the original intention of the authors' of such instruments/good practices. Clarifications are provided at the outset of each subsection where this may be applicable. OECD sources are cited without prejudice to implementation.

5. And by implication the Principles of Corporate Governance (OECD, 2004) with which they are compatible. Chapter I of the Principles provides recommendations for corporate governance frameworks that promote "transparent and efficient markets".

## Chapter 2

### **OBTAINING COMPETITIVE NEUTRALITY: A COMPENDIUM OF OECD RECOMMENDATIONS, GUIDANCE AND BEST PRACTICES**

#### **2.1. Streamlining the operational form of government business**

##### *Introduction to streamlining the operational form of government business*

The reform trends in almost all OECD countries have been towards streamlining the operational form of government business activities, towards a more complete corporatisation of SOEs and other commercial entities. A number of commercial activities previously operated by government departments or as statutory corporations have in the course of this process been subjected to the disciplines of corporate law and in some cases stock market listing. This has limited their scope for anti-competitive practices and non-commercial objectives more generally. Similar benefits have arisen from separation of ownership from regulatory functions in a number of jurisdictions. The self-regulating monopoly operators (especially in the network industries) of an earlier era have in many cases been replaced by corporations overseen by independent sector and competition regulators.

Corporatisation has meant that state-owned companies are expected to run according to good corporate governance practices such as those recommended by the SOE Guidelines and by implication the Principles for Corporate Governance. This implies:

- establishing a distinct legal status, preferably according to ordinary company law or else by corporate charter or statutory authorisation;
- identifying a clear relationship with the government and government ownership; and,
- full awareness of obligations by SOE management to play by rules of the market place.

The gradual corporatisation of SOEs has also required a redefinition of the role oversight institutions and regulatory functions, among other things good practice suggests:

- an unambiguous separation between the state ownership functions and other state functions that influence market conditions;
- separation of ownership from the regulatory authority, particularly with regard to market regulation; and,
- a divorce from day-to-day management of SOEs, without intrusion on SOE board independence.

However, it does not follow from this that concerns about competitive neutrality have wholly abated. For starters, where individual enterprises are engaged in a combination of public policy objectives and more conventional business activities, questions often arise about the

market-consistency of the business activities. Furthermore, the degree to which government activity is considered “business” matters. Commercial undertakings operated by government departments or autonomous institutions can be a source of non-neutrality, but not all activities are suited for corporatisation.

From a competitive neutrality point of view, it is easier to level the playing field if commercial activities are carried by an independent identity, operated at arm’s length from general government. A “textbook approach” to this problem would be a structural separation of the business and non-business parts of the SOE. However, dependant on the technologies, capital equipment, human capital, etc this is not always practically feasible, and sometimes where this is feasible it is not economically efficient. These recommendations along with other issues related to the commercialisation or corporatisation of SOEs are covered in the sections below.

### *OECD instruments bearing on streamlining the operational form of government business*

#### *SOE Guidelines*

Full corporatisation of government businesses can be obtained through a consistent implementation of **SOE Guidelines** (OECD, 2005). Guideline I.B recommends that governments “streamline the operational practices and the legal form under which SOEs operate”. This has implications for competitive neutrality, because it is easier to pursue neutrality if the competitive activities are carried out in an entity with an independent identity, operated at arm’s length from general government.

The key recommendations emerging from the annotations to Guidelines I.B are as follows:

- the legal form of SOEs should be based as much as possible on corporate law;<sup>1</sup>
- avoid creating a separate legal status, unless “absolutely necessary” to achieve stated objectives;
- governance bodies should have clear authority for steering the company; and,
- respect transparency and disclosure obligations.

The SOE Guidelines recommend other options if the legal form of the SOE cannot be changed. For example operational practices should be streamlined; and the SOE should be subject to the same regulatory requirements as private sector companies, either on a voluntary basis or by changing regulations in order to extend validity of their coverage to the SOEs in question.

In general, transparency and disclosure requirements are key to assuring the public that SOEs operate as well as possible according to market principles. This includes disclosing public service requirements, compensation received to fulfil them and accounting for them properly; and disclosing any different tax, regulatory or debt treatment. It also means that the SOE should be transparent about its objectives, especially if a choice is made not to fully corporatise; this includes being transparent about its commercial and/or political objectives (i.e. to protect national champions or pursue industrial policy objectives; to fulfil public service obligations; if the costs outweigh the benefits; if fiscal revenue is being protected, etc.). Remedies should be taken in order to level the playing field if the operational form of the SOE of these related objectives puts it an advantage or disadvantage *vis-à-vis* the private sector.

### *Council Recommendation concerning Structural Separation in Regulated Industries*

In 2001, the OECD Council adopted the **Recommendation of the Council Concerning Structural Separation in Regulated Industries** (OECD, 2001) suggesting to Member countries that they consider the implementation of structural measures in regulated sectors (especially public utility and network industries) undergoing liberalisation. It aims to shed light on the problems which may be faced by policy-makers when undergoing liberalisation, especially when incumbent firms control a bottleneck or essential facility (i.e. non-competitive activity) and, at the same time, compete in competitive parts of the industry against new firms which are seeking to enter. This is relevant because incumbents, usually SOEs or former-SOEs, which are active both on a competitive and non-competitive basis, may give preference to their own competitive activities by controlling the terms and conditions at which rival firms in the competitive component have access to the non-competitive component. A proper set of incentives must be in place in order to change such behaviour. The recommendation discusses the use of “behavioural” measures and the use of “structural” measures, as described below (Box 2.1). In general, the recommendations advocate structural separation, but recognise that careful consideration of costs and benefits must be made. Costs and benefits should consider the economies of certain sectors, especially those demonstrating natural monopoly characteristics, which can benefit from remaining integrated; furthermore, considerations must be made in terms of the overall outcome for consumers.

#### **Box 2.1. Recommendation 1 of the Council Concerning Structural Separation in Regulated Industries**

When faced with a situation in which a regulated firm is or may in the future be operating simultaneously in a non-competitive activity and a potentially competitive complementary activity, Member countries should carefully balance the benefits and costs of structural measures against the benefits and costs of behavioural measures.

The Recommendation was accompanied by a detailed report that considered the benefits and the costs associated with the adoption of structural separation policies (OECD, 2001, *Public Utilities*) and a review of the public utilities sector. The 2001 report describes the distinction between these two types of measures as “*those that primarily address the incentives on the incumbent to restrict competition (‘structural’) approaches, and those that primarily control the ability of the incumbent to restrict competition (‘behavioural’) approaches*”, and emphasises that “[u]nder behavioural approaches, the regulator must struggle against the incentives of the incumbent to deny, delay or restrict access. Compared to the incumbent firm the regulator is usually at a disadvantage with respect to information and to the possible instruments of control. As a result, the level of competition under behavioural approaches is less than if the incumbent did not have the incentive to restrict competition. Certain tools, such as accounting separation, management separation or corporate separation, are not effective on their own, but may support other approaches, such as access regulation”.<sup>2</sup>

According to the public utilities review, there are a variety of tools or policy approaches that can be used in structural separation. These include:

1. the regulation of access to the non-competitive component of an integrated firm;
2. ownership separation of the competitive and non-competitive components;
3. club or joint ownership of the non-competitive component by competing firms in the competitive component;

4. placing the non-competitive component under the control of an independent entity (“operational” separation);
5. separation of the integrated firm into smaller reciprocal parts; and/or
6. limitations on the ability of the integrated firm to compete in the competitive component.

The strengths and weaknesses of each approach vary, and are largely dependent on the sector (Box 2.2). For example, operational separation is most common in the electricity industry. Club ownership is most common in the airport sector (it is common for airlines to jointly own the slot co-ordination function). Vertical ownership separation is relatively more common in the electricity and gas sectors. Access regulation is found in all of these industries and is especially common in telecommunications and post. Separation into reciprocal parts is rarer, but is found in railways and telecommunications.<sup>3</sup>

#### **Box 2.2. Structural Separation: Sectoral Considerations**

Following the **Council Recommendation concerning Structural Separation in Regulated Industries** the OECD has carried out a number of sector specific reviews of regulated markets which have included discussion on aspects of structural separation. A few examples of such work can be found as follows:

- Structural Separation and the Gas Industry In Europe
- Next Generation Access Networks and Market Structure
- Structural Reform in the Rail Industry
- Competition and Regulation In the Water Sector
- The Benefits and Costs of Structural Separation of the Local Loop
- Restructuring Public Utilities for Competition (OECD, 2001)

A regular update on member country experiences with structural separation has been made. They all conclude that structural separation is a remedy of continued relevance. The reports include:

- Recent Experiences with Structural Separation: A Report to the Council on Implementation of the 2001 Recommendation Concerning Structural Separation In Regulated Industries
- Report on Experiences with Structural Separation

#### *Report on Regulatory Reform and its Recommendations*

The **Report on Regulatory Reform and its Recommendations** (OECD, 1997) were endorsed by the OECD in 1997. The Report’s recommendations constitute a plan of action for governments to drive their regulatory reform programmes according to the basic principles of “good regulation”. The Recommendations promote a level playing field among all economic actors and in principle apply to the activities of state-owned enterprises.

The recommendations are entirely consistent with competitive neutrality in that they propose: streamlining the operational form of business; structural separation; reducing the power of market incumbents; and guaranteeing access to all market entrants on a transparent and non-discriminatory basis. Full administrative separation of responsibilities for ownership and market regulation is a fundamental prerequisite to creating a level playing field and avoiding competitive distortions. The

recommendations refer in particular to the utility networks, promoting either physical or accounting separation of the monopoly network from competitive activities to ensure non-discriminatory access by firms upstream and downstream (Box 2.3). Such separation is also advocated by the SOE Guidelines.

Where separation is not possible, a periodic review of the commercial and non-commercial objectives of the SOE should be made to evaluate the need for continued government stake/control (see also Section 2.6).

**Box 2.3. Excerpt from 1997 Regulatory Reform Recommendations**

**Recommendation 5: Reform economic regulations in all sectors to stimulate competition, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.**

*“Promote efficiency and the transition to effective competition where economic regulations continue to be needed because of potential for abuse of market power. In particular: (i) separate potentially competitive activities from regulated utility networks, and otherwise restructure as needed to reduce the market power of incumbents...”*

***Other good practices and related guidance***

*Privatisation in the 21<sup>st</sup> Century: Recent Experiences of OECD Countries*

The Corporate Governance Committee’s WPSOPP published a paper entitled **Privatisation in the 21<sup>st</sup> Century: Recent Experiences of OECD Countries** (OECD, 2009) which discusses the process of corporatisation across OECD economies. It discusses some of the costs and benefits associated with corporatisation. Aside from the benefits which are discussed in detail by the good practices promoted in SOE Guidelines, in the case of most networked sectors legally incorporating what were once operating as successors of government departments brought transparency. This is highlighted in the specific case of public utilities, as described in a 1999 review published by the same Committee, pointing out that, “by adhering to corporate accounting standards applicable to the private sector, the previously impenetrable picture of the enterprise’s use of its assets become clearer. This gives to both the public and the government a better idea of the costs involved in particular strategies and decisions related to the development of utilities. Finally, hidden subsidies and cross-subsidies come to the fore; their need is reassessed and they are tackled in a more direct fashion. Corporatisation helps make the public interest aspects transparent and allows for better targeting of subsidies and adjustment policies”.<sup>4</sup>

According to the report, although corporatisation also comes with a number of costs, including managing complex restructuring which at times includes having to face pressures from public employees and politicians, the benefits of transparency often outweigh the costs.

***Conclusions on streamlining the operational form of government business***

An important aspect to ensuring competitive neutrality is related to the level of corporatisation of government business and the extent to which commercial and non-commercial activities are structurally separated. Separation makes it easier for the commercial activities to operate in a market-consistent way, but may not always be either feasible or economically efficient. Where individual enterprises are engaged in a combination of public policy objectives and more conventional business activities, questions often arise about the market-consistency of the business activities.

The main OECD instruments, guidelines and best practices deal with the following aspects of these issues:

- To level the playing field in regulated sectors, OECD recommends structural measures, separating commercial and non-commercial activities, to the extent that benefits outweigh costs. These recommendations are applicable to SOEs as well as other incumbents which maintain market power. (Council Recommendation on Structural Separation, Recommendation on Competition Policy and Exempted or Regulated Sectors and Report on Regulatory Reform.)
- The SOE Guidelines recommend corporatising commercial and, if feasible, non-commercial units to the greatest extent possible, among other reasons, to maximise transparency and accountability.

## **2.2. Identifying the direct costs of any given function**

### ***Introduction to identifying the direct costs of any given function***

Developing appropriate cost allocation mechanisms is essential for authorities to be able to enforce competitive neutrality. Aspects of a public undertakings' cost structure may put it at an advantage or disadvantage *vis-à-vis* the private sector. For example the status of its personnel might increase staff costs, whilst the cost of capital could be less. Such cost advantages or disadvantages should be made clearly identifiable, quantifiable and accounted for. In order to ensure competitive neutrality, the cost structure of a government commercial undertaking should take into account the following points (identified in the following sections):

- additional costs derived from assigned public service obligations;
- estimated advantages obtained in terms of finance, taxation as well as the impact of specific regulations applicable; and
- estimated income that the State budget should receive as a compensation for the amounts invested in these entities, considering the public service obligations and the financial and regulatory advantages previously calculated.

Where commercial activities are carried out by unincorporated public entities a main challenge is that these often share assets with the other parts of the government sector. Cost-sharing can artificially lower costs attributed to the commercial activities and enhance a public entity's ability to price more aggressively than competitors. Where this is the case, identifying cost allocation is particularly important if oversight/regulatory entities are committed to address these imbalances. If they are not, making such information public is especially important because it ensure that potential or actual competition has adequate information to determine whether or not it is feasible to enter the market.

At the same time, high standards of accountability and transparency must be maintained among the incorporated SOEs. Among other things, this is necessary to ensure that public service obligations (and often related subsidies) do not provide a conduit for cross-subsidising these enterprises' competitive activities (further discussed in Sections 2.3 and 2.4). Where the oversight of competitive neutrality is entrusted with independent agencies (as opposed to the government owners of SOEs) and compensation is provided through the public purse, the need for transparency around the operators' cost structure is further accentuated.

## *OECD Instruments bearing on identifying direct costs of any given function*

### *SOE Guidelines*

The **SOE Guidelines** (OECD, 2005) require that any costs related to the fulfilment of special obligations be identified to the market and general public (Guideline I.C). Identifying costs also may require disclosing financial assistance received from the state (Guideline V.E.4 – Box 2.4). The SOE Guidelines recognise that other types of benefits such as discounted financing, exemptions from regulations, etc. should be reported transparently. The challenge is to evaluate costs taking into account either advantages or disadvantages faced by SOEs. Effective implementation of the Guidelines is essential to ensure a level playing field between the state and the private sector. But, identifying such costs may require a complex system of accounting to evaluate what share of costs are being used to support non-commercial objectives versus commercial priorities, particularly if costs are shared. In order to identify costs, a mapping of the SOEs cost structure has to be performed, and the costs of meeting obligations must be evaluated (for more on this see Section 2.4 on accounting for public service obligations). Adequate cost coverage of the special obligations of SOEs is needed to avoid, on the one hand, that public enterprises are disadvantaged *vis-à-vis* profit maximising private firms and, on the other hand, that overcompensation of special obligations serve as a *de facto* subsidy.

#### **Box 2.4. Relevant SOE Guidelines**

**I.C:** Any obligations and responsibilities that an SOE is required to undertake in terms of public services... should be clearly mandated by laws or regulations...and related costs should be covered in a transparent manner.

**V.E.4:** Disclose “any financial assistance, including guarantee, received from the state”.

### *Other good practices and related guidance*

#### *Best Practices for Budget Transparency*

The **Best Practices for Budget Transparency** (OECD, 2001), endorsed in 2002 by the Working Party of Senior Budget Officials, is designed as a reference tool in order to increase the degree of budget transparency in government. The Best Practices define “government” in line with the System of National Accounts which encompasses the non-commercial activities of government. The activities of state-owned enterprises are purposefully excluded from the definition. However, the best practices do apply to government activities where unincorporated commercial activities remain an integral part of the general government sector (i.e. they cannot be considered quasi-corporations and are not accounted for separately).<sup>5</sup> With this in mind, many of the budget transparency practices are applicable in a competitive neutrality context (Box 2.5).

#### **Box 2.5. Related Excerpts from the Best Practice Guidelines for Budget Transparency**

Guideline 1.1: The budget should contain a comprehensive discussion of the government’s financial assets and liabilities, non-financial assets, employee pension obligations and contingent liabilities in accordance with Best Practice 2.3-2.6.

The best practices place importance on integrity, controls and accountability in the budget process (Guideline 3). The role of internal audit is emphasised, together with the role of external audit by Supreme Audit Institutions. Scrutiny by the public and parliament is considered an integral part of reporting. These practices are in line with ensuring transparency and disclosure of unincorporated government business activity.

The specific best practices include key elements which bear on identifying costs and assets in terms of reporting. In particular, mid- and yearly reporting should contain comprehensive accounts of the government's assets (financial and non-financial), liabilities, employee pension obligations and contingent liabilities (Guidelines 1.1, 1.4 and 1.5). Specific disclosures such as non-financial assets include property and equipment costs (Guideline 2.4); employee pension obligations include contributions made towards those benefits and actuarial assumptions (Guideline 2.5); contingent liabilities include government loan guarantees and insurance, and other significant liabilities (e.g. legal claims) (Guideline 2.6). For government entities that perform both commercial and non-commercial activities and which do not already separate accounts, the challenge is to identify which costs and assets are shared; and to determine and transparently disclose which proportion are attributed to commercial activities.

#### *Best Practice Guidelines for User Charging for Government Services*

The **Best Practice Guidelines for User Charging for Government Service** (OECD, 1998) was endorsed by the Public Management Committee in 1997. The guidelines explicitly raise the issue of adequate cost allocation methods in order to best determine user charges for government services. According to the best practices, full costs must be determined and should reflect costs faced by the private sector; revealing full costs will also make transparent the degree of subsidy involved in providing a service (Box 2.6). The guidelines specifically condemn cross-subsidisation practices between paid commercial and non-commercial government services especially under monopoly service provision. The guidelines further emphasise that costs calculations should factor in joint/shared costs (such as cost of capital).

The guidelines do not identify specific methods for calculating costs, but they do heed that such methods are complex and as such should be employed pragmatically depending on the scale of service. For example, it may be easier to calculate "reasonable estimates" for smaller scaled services while for larger scale services full "cost accounting systems" should be elaborated.

In particular prices are an important factor and should accurately reflect all items of cost. For what concerns prices charged at below costs, the guidelines stipulate that if costs cannot be recovered, the degree of subsidy should be made transparent. The guidelines tend to favour charging users for actual costs while ensuring equity considerations via other means such as through taxes or other benefits.

The Guidelines draw on a number of national best practices which cover different aspects of user charging for government services, they include: restricting what commercial services can be offered by government organisations and setting special provisions which apply to the costing of such services (Finland); benchmarking operations against best practice in the private sector in order to improve services (Australia); and, putting into place extensive cost accounting systems in order to attribute all costs to specific users (United States).<sup>6</sup>

## **Box 2.6. Excerpts from Best Practice Guidelines for User Charging for Government Services**

### **Determine Full Costs**

- The full cost of providing each service that is subject to a charge should be determined. This costing should be carried out regardless of whether the intention is to recover fully or only partially the cost of providing the service. If the intention is not to fully recover costs, this information will make transparent the degree of subsidy involved in providing the service.
- Full costs include not only the direct costs of the service, but also costs shared with other activities (joint costs) and such non-cash costs as depreciation and cost of capital.
- Determining full costs can be complex, especially when joint costs must be allocated. The effort made in costing should be commensurate with the scale of the service being charged for. In the case of small scale services, it may be appropriate to use reasonable estimates for allocating joint costs rather than elaborate cost accounting systems.
- This costing should be reviewed periodically to ensure its accuracy.

### **Appropriate Pricing Strategy**

- Wherever relevant, pricing should be based on competitive market prices.
- In other cases, pricing should be based on the principle of full cost recovery for each service unless there is a clear rationale for less than full cost recovery. This serves to enhance an efficient allocation of resources in the economy.<sup>7</sup>

### **Ensuring Competitive Neutrality**

- If an organisation is supplying a commercial service in competition with the private sector while retaining a monopoly provision of another service, care needs to be taken to ensure that the monopoly service is not subsidising the commercial service.
- When pricing such services, care needs to be taken to ensure that their costing is accurate and that they incorporate all items of cost faced by private sector entities.

### **Recognise Equity Considerations**

- When a user charge does not represent full cost recovery, the degree of subsidy should be transparent to those providing and monitoring the service.
- It should be recognised that measures through the tax and benefit system may be a more efficient means of ensuring equity than reduced charges.

## *Regulating Market Activities by the Public Sector*

Where a case cannot be made for either corporatising or ring-fencing business activities, a range of frameworks can be used to calculate cost reflective prices. The paper entitled **Regulating Market Activities by the Public Sector** (OECD, 2004), published in 2004 by the Competition Committee, illustrates one approach. The methodology determines full costs and includes competitive neutrality adjustments. It involves calculating the cost base for each activity; the competitively neutral cost benchmark; and the competitively neutral market price (Box 2.7).

### Box 2.7. Calculating full costs and factoring in competitive neutrality adjustments

**The cost base for each activity:** includes all of the direct (labour, materials, service), indirect (HR and IT services, administration, finance costs) and depreciation costs of the activity and accounts for all of the real resources used to produce the service. In order to assess these costs, agencies need to have in place adequate financial management structures that allow costs, including indirect costs to be allocated to particular activities. Accrual accounting, output based costing and asset valuation systems, for example, would generate the information needed to calculate the cost base of a government business activity.

**The competitively neutral cost benchmark:** includes the cost base plus an adjustment for any advantages or disadvantages the activity receives because of government ownership (adjustments for private sector rate of return, taxes, regulation and legislation). It needs to be demonstrated that the constraints are externally imposed, exceed those facing the private sector and subsequently impose a cost on the government agency. In many cases it would be preferable to remove the cost disadvantage rather than trying to adjust prices.

**The competitively neutral market price:** is different than the cost calculation as it factors in what the market will bear (which may change over time); the level of competition between service providers; any technological advantage available to other suppliers of goods and other service providers; and market strategic price behaviours, such as the introduction of loss leaders or cross product subsidisation. Pricing needs to cover the cost benchmark in the medium to long run.

*Source:* OECD (2004), *Regulating Market Activities by the Public Sector*, pp. 34-35. Also see South Australian Department of Treasury and Finance (2000), *A Guide to the Implementation of Cost Effective Pricing: A part of competitive neutrality policy*, p. 11.

According to good practice, accounting systems should be designed to disaggregate direct costs in a fairly straightforward way. Allocating indirect costs is more complex, but the guiding principle is that that costs should be calculated to ensure economic efficiency and fairness. The publication proposes possible methods for cost allocation including fully distributed costs; marginal cost; incremental cost; and avoidable cost and provides examples of situations when some methods are more appropriate than others (see attachment 3 of the cited document). Where the public sector may be faced with cost disadvantages, an analysis should be made to determine whether such costs are imposed due to external factors and that costs exceed those which the private sectors faces. In general, good practice prefers removing cost disadvantages over adjusting prices. (Refer to Box 2.13 for further discussion of cost calculation methods.) If prices cannot match the cost benchmark over the medium to long-run, in order to maintain competitive neutrality, the government should either discontinue providing such services at non-neutral prices or consider subsidising it (in a transparent and accountable way) if they are necessary for social/political reasons.

#### *Best Practice Guidelines for Contracting Out Government Services*

The **Best Practice Guidelines for Contracting Out Government Services** (OECD, 1997), endorsed at the 1996 Annual meeting of Senior Budget Officials and subsequently approved by the Public Management Committee, provide specific guidance and identify best practices for contracting out of government services. In particular the best practices (Guideline 5) touch upon the issue of identifying costs for this purpose in order to establish valid comparisons in evaluating contract proposals whether emanating from in-house service providers or external service providers (Box 2.8, also see Section 2.8).

The competitive neutrality debate resurfaces when a third party contractor is expected to compete with a public service provider. A public service provider may not fully reflect its costs if it is not taking into account a number of factors which could put it at a disadvantage or advantage *vis-à-vis* the private

sector. The guidelines suggest that a public service provider should take into account any shared financial (overhead costs) and non-financial costs (depreciation, cost of capital and tax treatment). Costs should also include staffing liabilities, salaries, benefits, and pensions. A significant differentiating factor among public in-house and private bids could be the differences in treatment of such costs.

**Box 2.8. Best Practice Guidelines for Contracting Out Government Services –  
"Ensure Valid Comparisons"**

- A thorough costing of the present activity should be conducted and used as a benchmark for evaluating contracting out proposals. This involves identifying all costs related to the activity that is to be contracted out. These include not only the direct costs of the activity, but also its share in overhead costs and such non-cash costs as depreciation and cost of capital. The treatment of the present activity for taxation purposes also needs to be taken into account.
- If the present activity can be restructured in such a way as to offer improved performance, then this should be similarly costed and used as the benchmark for evaluating contracting out proposals.

*Accountability and Transparency: A Guide for State Ownership*

**Accountability and Transparency: A Guide for State Ownership** (OECD, 2010), issued by WPSOPP, is a guide intended to facilitate the practical implementation of the SOE Guidelines in the area of transparency and accountability. It provides policy-options and practical steps as well as examples of good practice that promote good governance in SOEs. The Guide has a dedicated section (Chapter 1.5) entitled “Identifying, costing and funding public service and other special obligations” which provides guidance on how to ensure a level playing field when dealing with both special obligations and financial benefits associated with such obligations. It recommends a number of cost identification techniques which are discussed in detail in the section of this paper covering “Accounting for public service obligations”. Notably, it calls for identifying full costs, including shared costs, and other costs such as existing or contingent liabilities (i.e. pension liabilities). (See Section 2.4 for more details.)

***Conclusions on identifying the costs of any given function***

Identifying the costs of any given function of commercial government activity is essential if competitive neutrality is to be credibly enforced. However, to achieve it depends on the level of incorporation of the business. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling public service obligations (if applicable). If public service obligations are subsidised by the public purse, costs should be identified in a transparent manner to ensure neither over compensation nor under compensation. For unincorporated units of general government which share costs between commercial and non-commercial activities, the concern is that the attribution may often not be feasible. Existing OECD guidance and recommendations concerning this topic include, among other things, the following:

- Best Practices in Budget Transparency recommend disclosing the proportion of shared costs and assets that are attributed to commercial activities, when non-commercial activities are not conducted separately.
- A number of recommendations propose that the degree of subsidies received by the State should be made transparent (SOE Guidelines, Accountability and Transparency Guide and Guidelines for User Charging for Government Services). The first two of these address incorporated SOEs only; the latter address general government as a whole.

- Other guidelines recommend removing any cost advantages or disadvantages which may exist due to public ownership (Regulating Market Activities by the Public Sector, and Guidelines for Contracting Out Government Services), mostly with applicability to both SOEs and general government.

### 2.3. Achieving a commercial rate of return

#### *Introduction to achieving a commercial rate of return*

A fundamental difference between the government and the private sector is the basis on which production is undertaken. For government, the production of goods and services is often determined by public policy objectives, while the private sector is motivated by profit maximisation. Unincorporated government products and services are aimed at benefiting individuals or society at large and are usually at prices which are not motivated by solely by earning objectives but also by other considerations such as equity and social welfare. Ambiguities may arise when the public sector undertakes production on a commercial basis, with objectives beyond those stated above. Government commercial activities have been described to have the following characteristics: the government intends to charge for the service; the activity is commercial in nature; there are no restrictions on profitability; and there is actual or potential for competition.<sup>8</sup>

Competitive neutrality requires that government businesses earn a market-consistent rate of return (ROR) on the assets they use for providing the relevant activities. A market-consistent ROR would be one that is comparable with what is earned by the majority of firms within the same industry. The importance for competitive neutrality derives from that fact that, if government businesses were not required to earn a commercial ROR, they would be able to undercut competition by factoring lower profit margins into their pricing. Some government services are offered for a fee (in order to recover costs) but are not offered on a commercial basis. Such services would not be considered as non-compliant with competitive neutrality.

One key lever to address competitive neutrality issues is, therefore, to require that government business activities earn a reasonable rate of return on the capital employed and to set appropriate dividend targets. It should, however, be noted that competitive neutrality does not require government businesses to achieve a given ROR on every transaction or even in each budget period. A ROR requirement does not preclude SOEs from differentiating or varying their profit margins in the same way as privately owned enterprises do. Its main purpose is to prevent cross-subsidisation from the government's budget-funded activities.<sup>9</sup> Doing so will change the incentive structure for government businesses, and ultimately will alleviate wasted public resources due to inefficient SOEs. Some of these points are reflected in the instruments and best practices covered in this section.

#### *OECD Instruments bearing on achieving a commercial rate of return*

##### *SOE Guidelines*

As a part of its ownership functions the **SOE Guidelines** emphasise the need for the government to define the overall objectives of the SOE. As specified in the annotations to Guideline II.A, part of this exercise involves identifying specific targets among which include the ROR and dividend policy (Box 2.9). The purpose of setting such targets will serve to monitor the SOEs performance in meeting specific objectives such its degree of market orientation. Furthermore, the identification of such objectives should be made available in a transparent manner to the public and oversight institution as a means to monitor its performance.

### Box 2.9. Excerpts from the SOE Guidelines

**Guideline II.A. The government should develop and issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy.**

Annotations:

*"The objectives may include avoiding market distortion and the pursuit of profitability, expressed in the form of specific targets, such as rate-of-return and dividend policy. Setting objectives may include trade-offs, for example between shareholder value, public service and even job security."*

Making such objectives transparent will also enable economic agents to understand the motivations behind various commercial and financial decisions taken by the SOE, especially if it does not follow a profit maximisation objective. For example, if the SOE does not pursue a profit maximisation strategy, it should be justified and coherent with its objectives and should be reflected in its reporting.

#### *Other good practices and related guidance*

##### *Regulating Market Activities by the Public Sector*

The publication **Regulating Market Activities by the Public Sector** discusses what appropriate rates-of-return should be expected of SOEs pursuing commercial and non-commercial objectives. Similar to good practices highlighted in the sections above, the publication also suggests that ROR should be equivalent to that earned by similar private sector businesses. In order to set appropriate ROR objectives, a calculation should be made to identify costs and to factor them into the pricing of a good or service. Determining costs and setting the appropriate prices are related but different exercises; as such identifying costs is covered separately in Section 2.2. According to the publication, prices will depend on a number of factors including: what the market will bear (which may change over time); and, the level of competition between service providers. Determining appropriate price settings depends on the competitive neutrality cost benchmark (Box 2.7), which in turn should be factored into prices. As a general rule, a business should earn a commercial ROR over a reasonable period of time.

The publication describes a number of methods which can be used to calculate returns, but their complexity and level of precision vary and each has its own merits depending on the availability of accounting information available for the company. In general, the rule of thumb for determining the ROR is that the target should reflect the long term government bond rate (the risk free rate) plus an appropriate margin for risk. The methods discussed the paper include the weighted average cost of capital (WACC), the broad-banding approach, and targeting a uniform rate of return (Box 2.10).

The publication also emphasises that determining the ROR should take into consideration whether or not the SOE pays dividends, and if so on which basis. Some SOEs are absolved from paying dividends or any other returns to shareholders; this allows SOEs to incur losses without fear of the owners selling their equity stake.<sup>10</sup> If dividend payments are too low, government business activities may have an advantage over their private sector competitors because they face a lower cost of equity funding, whereas the opposite can tip the balance in the other direction. One approach to ensuring that dividends are set consistent with competitive neutrality is to base government dividend policies on the framework required by corporate law.

### Box 2.10. Methods used to calculate rate of returns

#### WACC method:

- Requires estimation of variables such as the required rate of return on debt and equity and the market values of assets, debt and equity
- Uses the cost of capital as the hurdle rate the business must achieve and is based on the presumption that a financially viable business must earn a return that is above its cost of capital.
- Most appropriate for large government business activities, particularly if there are well-established private sector competitors so that benchmark data on the cost of equity is available

#### Broad-banding approach:

- Requires estimation of a premium for each level of market risk and cost of capital (at long term bond rate)
- Most appropriate for businesses with high, medium and low levels of market risk

#### Uniform rate of return:

- Requires government businesses to generate a set level of return across all their assets
- Uses the typical WACC calculation for agencies with *average* market risk
- Simplest method of establishing a rate of return target and does not take into account that investors would expect higher returns from risky businesses and lower returns from less risky businesses

### *Accountability and Transparency: A Guide for State Ownership*

**Accountability and Transparency: A Guide for State Ownership** (OECD, 2010) suggests benchmarking SOEs with private companies across the same industry, as a way to evaluate performance. In order to benchmark performance, the ROR is considered to be a useful proxy, as it focuses on the cost of capital. The guide mentions that estimating the cost of capital for SOEs is not straightforward as it involves a series of estimations that are based on judgment and assumptions, especially for what concerns risk. The guide covers other methods which can be used to evaluate performance of SOEs in cases where performance comparisons are made across industries. These methods place emphasis on evaluating value creation, they include: economic value added (EVA) performance measurement and the economic profit methodology (Box 2.11).<sup>11</sup>

### *Predatory pricing*

The Competition Committee reports on **Predatory Pricing** (OECD, 1989 and 2004) discuss theories of price and non-price predation, as a response to increasing concerns over the pricing practices of recently privatised SOEs.<sup>12</sup> The concern is that the newly privatised firms, often dominant in their markets, will unfairly seek to protect their positions against new entrants using anti-competitive practices such as predatory pricing. SOEs will also be more inclined to engage in anti-competitive (and rarely profitable) exclusionary pricing strategies, such as predation, without fear of falling stock prices when losses are incurred by private listed companies due to the below-cost pricing.<sup>13</sup>

### **Box 2.11. Methods used to estimate performance of SOEs on the basis of cost of capital**

#### **EVA:**

- Measures performance by tracking changes in a company's economic value from a shareholder perspective
- Calculates net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise
- Encourages a mindset in which managers recognise that all capital has a cost and therefore they should allocate capital to its most effective use
- Applicable to a wide range of industries consistently

#### **Economic Profit Methodology:**

- Measures value creation as the after-tax operating profit less the cost of capital charge for the operating assets.
- Excludes the gains and losses arising from non-operating assets, the financing flows and tax impacts of the debt/equity capital structure
- Applicable to all business in different sectors across the portfolio

The report goes into detail about both theory and practices, which are discussed in subsequent reports published by the Competition Committee in 2004.<sup>14</sup> The report points out that given SOEs incentive structures and their role in providing public services, traditional methods of identifying anti-competitive practices may not be adequate. Several issues arise as identified by literature: the first is that SOEs can engage in non-recoupment predation; secondly, cost-based predation tests may not be suited to SOEs.<sup>15</sup>

Predation strategies are obviously not consistent with competitive neutrality, and other mechanisms other than traditional cost-based predation tests should be designed. The report suggests that once appropriate costs accounting mechanisms are identified, public business entities must be benchmarked against similar private firms.

### ***Conclusions on achieving a commercial rate of return***

Achieving a commercial rate of return is an important aspect in ensuring that government business activities are indeed operating like comparable businesses. If they do not have to earn returns at market consistent rates, private sector competition are undercut, and even more so if SOEs pursue aggressive pricing policies. Furthermore, setting appropriate rates of return for each separate line of commercial activity is an important factor to ensure that SOEs are not engaging in cross-subsidisation. The main OECD guidance bearing on this topic is found in the following areas:

- According to OECD guidance, SOEs should earn rates of return equivalent to that of private sector businesses; and performance should be benchmarked with similar business activities in the same industry. (Regulating Market Activities by the Public Sector, Accountability and Transparency Guidelines, Predatory Pricing Reports.) The guidance is applicable to the commercial activities of general government and of incorporated SOEs.

- SOEs and other types of government businesses may be required to pursue objectives other than profit maximisation. OECD guidance holds that such objectives should be made transparent and should not be used to undercut actual or potential competition. (SOE Guidelines, Best Practice Guidelines for User Charging for Government Services.)
- While good practice acknowledges the role of traditional competition-law based approaches to anti-competitive practices (e.g. cost predation tests), it does recommend that other approaches may be more adequate if SOEs do not maximise profits or are allowed to earn lower rates of return (e.g. appropriate cost accounting mechanisms and comparing performance across industries). (Predatory Pricing, Accountability and Transparency Guidelines.)

## 2.4. Accounting for public service obligations

### *Introduction to accounting for public service obligations*

SOEs operating in a competitive environment are often expected to provide essential public goods alongside their commercial activities. These obligations may include providing services to remote or scarcely inhabited areas which are part of universal service obligations (e.g. maintaining postal and telecommunication services in outlying areas), or providing essential utilities at affordable rates, etc. In order to balance commercial and non-commercial activities, service providers have a legitimate right to be compensated for delivering public services, especially if complying with such obligations becomes unprofitable.

There are circumstances where competitive neutrality may be at odds with achieving these dual objectives and it is important that service delivery objectives be clearly identified and that costs are properly calculated to minimise the distortionary effects of compensation. On the one hand, inadequate calculation of costs may put SOEs at a disadvantage *vis-à-vis* their private competitors. On the other hand, if SOEs are over compensated for public service obligations then the playing field becomes tilted in the opposite direction. In practice it may also be complicated to decide whether or not certain requirements of SOEs qualify as public service obligations. Such ambiguity lends itself to rationalisation of protecting SOEs or incumbents from competition. In some cases public planners see it as easier to continue providing public services through fully controlled entities. In other cases, a common practice is to allow incumbents to maintain monopoly rents in some of their activities and use these to compensate for their PSOs (this is often the case in specific sectors with targeted regulation giving monopoly rights to a single operator). However, when some of these activities become exposed to actual or potential competition these practices are generally not consistent with competitive neutrality.

Increasingly governments rely on market mechanisms in the provision of public services for example by tendering public service obligations among public and other providers. The main rationale is to increase efficiency of public services, improve their quality, lower costs, and in some cases make them more affordable. Market mechanisms can also increase consumer welfare by providing more choice and respond to consumer tastes and preferences, thereby improving efficiency. Market mechanisms in public service delivery can be provided in different types of market arrangements, ranging from public monopolies funded through general taxes to competitive private providers funded by user fees. Market arrangements differ considerably from country to country and according to the type of services being offered and in some cases differing considerably from education and health to garbage collection.<sup>16</sup> As governments adapt their services to market conform, offering their services on a commercial basis, questions of competitive neutrality come to the fore.

A common complaint heard by potential or actual private sector competition is that continued state ownership lends itself to market distortions. In particular, over compensation for public service delivery (including in the form of guaranteed monopolies in some activities) provides an opportunity for cross-subsidisation – e.g. by charging excessive revenues in certain “lucrative” areas in order to be able to fund public service obligations elsewhere. In addition to their effects on the competitive landscape, such practices also fall short of commonly agreed standards of transparency. However, they appear to be quite widespread. On numerous occasions, the first opening of segments of any given network industry to market competition has given rise to accusations of unfair “cherry picking” by the entrant.

No matter what the market arrangement or mechanism employed, public service obligations must be clearly identified and delivered according to pre-defined targets. Accounting for public services should ensure fair, adequate and transparent compensation. Moreover, service providers should be held accountable for the delivery of quality services and should be monitored to this effect. Some of these points are reflected in OECD Instruments, recommendations and good practices as described below.

### ***OECD Instruments bearing on accounting for public service obligations***

#### *SOE Guidelines*

The **SOE Guidelines** recognise that SOEs may be required to deliver public services alongside their commercial activities and thus should be compensated from the public purse in a manner that does not produce market distortions (Box 2.12); particular weight is placed on transparency and disclosure. To this end the Guidelines suggest that compensation should be provided according to specific legal or contractual mechanisms (I.C), that costs are disclosed transparently and reliably to the public and to supreme audit institutions (I.C, I.E and V.E) and that financials should be reported according to international accounting standards (V.D).

In cases where the SOE is supported by public funds, including state grants, subsidies or guarantees, the Guidelines identify the coordinating/ownership entities as responsible for reporting the use of such budget resources. In particular, SOE ownership entities should be accountable to the state’s supreme audit institutions responsible for auditing SOEs and monitoring the effective use of resources used for non-commercial activities financed through the public purse (II.E).<sup>17</sup> The Guidelines also consider it good practice to hold SOE ownership entities accountable to Parliaments (either directly or via state audit institutions) which are responsible for monitoring budget procedures (see annotations to guideline V.E).

Although the SOE Guidelines do not provide any specific guidance to SOE ownership entities on what accounting methods to adopt, beyond high quality internationally recognized standards,<sup>18</sup> they generally promote the separation of accounts for commercial versus non-commercial activities. Annotations to the Guidelines draw upon the example of the EU and the reporting of state aid in exchange for carrying out services of general interest (see annotations to guideline V.E). (Also see the following section for more on practical implementation of SOE guidelines and public service obligations.)

### Box 2.12. Relevant SOE Guidelines

**Guideline I.C Any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations. Such obligations and responsibilities should also be disclosed to the general public and related costs should be covered in a transparent manner.**

Annotations:

*"In some cases SOEs are expected to fulfil special responsibilities and obligations for social and public policy purposes...It is also important that related costs be clearly identified, disclosed and adequately compensated by the state budget on the basis of specific legal provisions and/or through contractual mechanisms, such as management or service contracts. Compensation should be structured in a way that avoids market distortion. This is particularly the case if the enterprises concerned are in competitive sectors of the economy."*

**Guideline II.E The co-ordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.**

Annotations:

*"The ownership entity should report on its own performance in exercising state ownership and in achieving the state objectives in this regards. It should provide quantitative and reliable information to the public and its representatives on how the SOEs are managed in the interests of their owners."*

**Guideline V.D** SOEs should be subject to the same high quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high quality internationally recognised standards.

Annotations:

*"A high level of disclosure is also valuable for SOEs pursuing important public policy objectives. It is particularly important when they have a significant impact on the state budget, on the risks carried by the state, or when they have a more global societal impact. In the EU, for example, companies that are entitled to state subsidies for carrying out services of general interests are required to keep separate accounts for these activities."*

**Guideline V.E** SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public. Examples of such information include: ... 4. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE.

Annotations:

*"Disclosure should include details on any state grant or subsidy received by the SOE, any guarantee granted by the state to the SOE for its operations, as well as any commitment that the state undertakes on behalf of an SOE. Disclosure of guarantees could be done by SOEs themselves or by the state. It is considered good practice that Parliaments monitor state guarantees in order to respect budgetary procedures."*

### *Principles for Managing Ethics in the Public Service*

The OECD adopted the **Principles for Managing Ethics in the Public Service** in April 1998. The Principles encourage high standards of conduct in public service, and review the institutions, systems and mechanisms available to promote public service ethics.

Designed for use by national and sub-national levels of government, they seek to integrate ethics into the broader public management environment. In particular, they call for transparency and disclosure of resources entrusted to public institutions (Box 2.28, Principle 6). Although developed as a means to enhance public sector integrity, they serve as a reminder to public agencies of their duty to disclose more generally how public resources are being spent. Unreliable calculation of costs for public service obligations gives rise to questions of ethical conduct and thus can be sanctioned if departure from good practice is purposefully overlooked or unremedied. In a competitive neutrality context, it holds individuals accountable, such as the management of SOEs and government departments involved in business activities.

### ***Other good practices and related guidance***

#### *Accountability and Transparency: A Guide for State Ownership*

**Accountability and Transparency: A Guide for State Ownership**<sup>19</sup> as introduced (see Section 2.2) specifically treats the question of public service obligations. The Guide walks through the seven main steps to determine how to cost for public service obligations: it advises that “special obligations” should be defined from the beginning in order to avoid ambiguity. A special obligation is defined as “a requirement to provide a product or a service at an affordable or unified price below their effective cost, to grant specific price concessions to targeted groups for redistribution purposes, or to use specific inputs with constraints or conditions not applying to private sector firms”.

Secondly, the guide suggests that the SOE and ownership entity should map existing special obligations in consultation with stakeholders and other concerned government departments. Thirdly, the ownership entity together with the SOE should evaluate the costs of special obligations. This calculation should take into consideration the opportunity cost of the resources used to fulfil public service obligations. The guidelines provide different methods for calculating costs, but draws particular attention to the “avoidable costs” technique as a commonly recommended method (Box 2.13).<sup>20</sup>

In general, the guide promotes adopting an industry-by-industry approach to measuring the cost of public service obligations, as the level of complexity and interpretation involved in disaggregating costs vary. Furthermore, the guide emphasises that special obligations for SOEs should not be taken as a *fait accompli*, in other words their delivery may be possible through more efficient mechanisms which should be debated in the political sphere (step four).

The fifth step involves identifying funding options based on different types of market arrangements. The guide recommends that direct funding from the state budget is the most transparent option as it makes costs explicit (i.e. costs can be subject to public scrutiny) and avoids market distortions (it creates the possibility to introduce competition and turns what was previously a non-commercial service into a commercial one). Administering direct funding could be developed along the lines of a contractual system, with indicators to assess performance (along international benchmarks) and funding mechanisms applied to compensate SOEs or other agents for related costs.

### Box 2.13. Methods for measuring the cost of public service obligations

There are four main methods to evaluate costs of “special obligations”:

**Marginal costs:** Includes costs that increase as a result of increased production or service. In principle, short-run marginal costs should be used, as they do reflect the real opportunity cost of supplying the additional product or service. But there are a series of practical difficulties in estimating marginal costs, related for example to the treatment of common and joint costs, especially when the same enterprise produces a variety of goods or services, or to the determination of the appropriate marginal unit of production. The distinction between short-run and long-term marginal costs might also be difficult concerning depreciation, for example, or in cases where capacity is not in a long-run equilibrium. In addition, these marginal costs might vary significantly according to the demand level, not even mentioning issues related to congestion in some industries. These difficulties can make the estimation of marginal costs extremely costly and complex.

**Fully distributed costs:** The idea is to include average variable cost plus a mark-up to cover fixed costs. A practical way to achieve this is to distribute fully the total costs of the enterprise by allocating them to all its different products or services. There again a number of allocation methods could be used. Fully distributed costs are considered as “fair” but tend to overestimate costs. This method ignores the discrepancies that often exist between average and marginal costs in the case of infrastructure industries. It is appropriate when the cost functions approach constant returns to scale.

**Avoidable costs:** Includes all costs associated with an additional block of output, including variable and capital costs whenever additional capacity is required. Actual costs should be considered, even if they might differ from best practice. The evaluation also takes into consideration capacity utilisation, with avoidable costs calculated at peak-load capacity to include capital costs incurred by the “additional” production or services deriving from the “special obligations”. Avoidable costs increase with the size of the incremental level of output to be considered, as more capital costs might thus be considered as “avoidable”. A distinction has thus to be made between short-run and long-run avoidable costs, the latter allowing incorporating additional capital costs. A related question arises with the estimation of capital costs and the appropriate rate of return to use for measuring the opportunity cost of capital. In some cases, a mark-up might also be added to avoidable costs to reflect a contribution to common costs.

**Stand-alone costs:** Costs incurred for producing an output in isolation. They by definition ignore economies of scale and scope. They result in significant over-estimation of the real cost of “special obligations”.

*Source:* Quoted directly from OECD (2010), *Accountability and Transparency: a Guide for State Ownership*, Box 1.10, p. 28. (Original source: Australian Industry Commission (1994), “Community Service Obligations: Some definitional, costing and funding issues”.)

Other funding options include: “accepting lower rates of return”, levies on users, cash transfers, voucher systems, etc. but they are less favoured by the guide compared with direct funding. The guide cautions against using cross-subsidies as they reduce transparency and can have negative effects on competition.

Step six calls for monitoring of special obligations to ensure that the SOE is fulfilling its objectives. Monitoring can be administered from the ownership entity, or directly by the purchasing ministry (i.e. if in-house services are being offered) and should be performance-based. Finally, step seven calls for disclosure of any other financial assistance (beyond compensation for special obligations) provided from the state to the SOE.

The seven steps provide useful course of action to practically implement the recommendations provided in the SOE Guidelines. Concomitantly, their application may be clear-cut for incorporated SOEs, but for unincorporated public entities, the division between commercial and non-commercial activities may require additional reflection on what constitutes commercial activity, whether it can be operationally separated or accounted for separately from non-commercial activities.

## *Best Practices for Budget Transparency*

The **Best Practices for Budget Transparency** (OECD, 2001), whilst not applicable directly to SOEs, has useful guidance on budget practices for commercial activities of the general government which are integrated with non-commercial activities. For what concerns reporting, the best practices recommend that governments should present all expenditures in yearly reports and account separately for ear-marked revenues or user charges. The text goes as follows: “Expenditure should be presented in gross terms. Ear-marked revenue and user charges should be clearly accounted for separately. This should be done regardless of whether particular incentive and control systems provide for the retention of some or all of the receipts by the collecting agency”. The essence of what is promoted is consistent with the principle of competitive neutrality. The recommendations are also complementary to the Best Practice Guidelines for User Charging for Government Service as far as concerned.

### *Best Practice Guidelines – Off-Budget and Tax Expenditures*

Off-budget expenditures is a mechanism used to transfer ear-marked levies to public enterprises fulfilling public policy objectives; the argument being that they can operate in a more “business-like” manner with some degree of autonomy from government control. This is in line with the **Best Practice Guidelines on Off-Budget and Tax Expenditures** (OECD, 2004), but this document goes further to recommend a cautious use of off-budget mechanisms and strict conditions for how they should be controlled (Box 2.14). The Guidelines emphasise that all “regular” and “off-budget” expenditures and revenues should be reported together “side-by-side”.

Budget experts argue that the guidelines can only be successful if budgets are controlled effectively. Otherwise, governments tend to operate by off-budget means in order to escape budget controls, shifting the burden of performing public policy objectives to off-budget accounts rather than showing them in public accounts. This behaviour can appear logical considering the incentive structures faced by government operating under specific limits on expenditures or deficits. In such circumstances, off-budget spending or borrowing allows public officials to abide by budget limits, while keeping public enterprises in business.<sup>21</sup>

#### **Box 2.14. Excerpts from the Best Practice Guidelines on Off-budget funds and Tax Expenditures**

##### **Guideline 1: Off budget funds should be avoided or only be allowed under the strict conditions:**

- a. that the funds are exclusively or largely financed by earmarked levies;
- b. that the expenditures and revenues of the funds are subjected to regular budgetary control.

**Guideline 2: All expenditures and revenues of off-budget funds should be integrated in the budget documentation that is presented to the budgetary authorities. Regular expenditures and revenues and off-budget expenditures and revenues should be shown in this documentation side-by-side.**

In a competitive neutrality context, these recommendations are relevant for a number of reasons. If effective budget control is missing, public enterprises supported by off-budget expenditure may be under less pressure to operate efficiently, especially if revenues and expenditure from public service delivery are derived from multiple sources and are not accounted for effectively.<sup>22</sup> Secondly, sub-national governments receive considerable transfers of budget from central governments for public services (public services at the sub-national level represent around 32% of total public expenditure in OECD economies<sup>23</sup>), but evidence demonstrates that in some cases “regular” budgeting is deliberately

circumvented to cope with budget constraints and to offset risks (Box 2.15). Lenient budget practices, coupled with little incentives on the part of local governments to engage in efficient regulation of sectors under its control can result in an unlevel playing field favouring incumbents or existing public service providers, even if a competitively neutral outcome could potentially be more efficient.<sup>24</sup>

#### **Box 2.15. Off-budget expenditure and state-owned financial institutions**

State-owned financial institutions are normally off-budget. While this can be an essential factor in ensuring the autonomy recommended by the SOE Guidelines, their off-budget status may result in activity which is not always motivated by market considerations or efficiency. Examples include lending at reduced rates or poor investment decision-making. According to an earlier study by the OECD, discipline on management is often weak and financial management of these institutions can be poor. Beyond undisciplined behaviour, issues arise for competitive neutrality when state-owned financial institutions are used to circumvent normal budgetary processes as instruments for fiscal expansion. This was the case in Mexico, notably during the run-up to the 1994 election and the subsequent financial crisis, and in Turkey. In Japan, retail savings deposits were channelled from the Post Office through the Trust Fund Bureau to state-owned enterprises. Although subject to Parliamentary approval, such practices are considered untransparent. Lack of proper oversight and lenient budgetary practices may advantage state-owned financial institutions and further suggest that they are not subject to the same financial discipline as private financial institutions.

*Source:* Van den Noord, *Public Expenditures*, p.15.

#### *Report on Universal Service Obligations*

The OECD Competition Committee published (OECD, 2010) a compilation of practices concerning Universal Service Obligations as they relate to competition. The report provides guidance on the competition problems that can arise as a result of public service obligations and how to limit restrictive practices in the marketplace. According to the paper, non-neutral practices are widespread in a number of sectors including telecommunications,<sup>25</sup> energy, postal service,<sup>26</sup> and transport. In these particular sectors due to universal or minimum service obligations, a common practice in many countries has been to allow incumbents with monopoly rights to finance loss-making customers with prices in excess of cost for the non-loss making customers using an implicit cross-subsidy. The authors echo the recommendations that have been made above, in reproaching the use of cross-subsidisation, as restricting competition often involves higher costs than would otherwise be the case. The paper posits that when evaluating claims for reimbursement, both costs and benefits should be considered. Benefits afforded to firm with monopoly rights include taking into consideration unprofitable customers becoming profitable, brand enhancement, and corporate reputation which are quantifiable. When such types of benefits outweigh the costs, the economic rationale for providing compensation (in whatever form they may be) is no longer valid.

In order to harness the potential for competition in areas where non-commercial services are being provided, the paper recommends defining service obligations carefully, and including pricing requirements and determination of beneficiaries in such a way which does not limit potential entrants to the market. In short, the paper suggests that compensation for carrying out public service obligations must be fair and measures should be put into place to ensure that compensation do not advantage public sector businesses or incumbents over private sector businesses.

#### *Economics Department Working Papers: Market Mechanisms in Public Service Provision*

The Economics Department Working Paper entitled “Market Mechanisms in Public Service Provision” (OECD, 2008) presents a set of institutional indicators which assess how sub-national governments harness market mechanisms in the provision of public services. Given that a significant

portion of public expenditure is in question, the use of market mechanisms is considered by the paper as a means to improve service delivery. The policy options derived from the report bear on competitive neutrality as they recognise that increasing use of market mechanisms for the delivery of public services can, in some cases, place different public actors at the sub-national level in competition with the private sector. Although ownership is not put into question, the paper highlights good practices in the use of market mechanisms based on its review of public service delivery in a number of OECD economies. In particular it promotes the use of “means-tested income support or grant subsidies to service providers” when employing market mechanisms for public services. The report notes that most services subject to competition should separate the provision of services from their funding, thus improving accountability. Accountability can be assessed according to “explicit minimum standards regarding service coverage” agreed upon in advance.

### *Promoting Performance: Using Indicators to Enhance the Effectiveness of Sub-central Spending*

The OECD Network on Fiscal Relations Across Levels of Government working paper entitled, *Promoting Performance: Using Indicators to Enhance the Effectiveness of Sub-central Spending* (OECD, 2008), provides a detailed review of indicator systems designed to measure and monitor sub-central service delivery and how to use such indicator systems. In particular, indicators can be useful to monitor the delivery of services, but they can also be designed to account for budget allocations when resources are transferred from the central government level (i.e. parliament) to the sub-central/municipal level. The report does not deal with competitive neutrality directly, but the indicators discussed and country examples provided can be a source of inspiration in the design of methods that ensure transparency, accountability and disclosure. Furthermore, indicators can be used to benchmark performance across municipalities and via different market arrangements. Once a number of observations have been made, benchmarking can be a useful way to determine actual costs and to develop more accurate/adequate compensation.

### ***Conclusions on accounting for public service obligations***

A competitive neutrality concern invariably arises when the provision of public policy priorities are imposed on SOEs which also operate in the market place. The extent to which market arrangements are used will depend on the national context and what is truly representative of the public interest. Competitive neutrality requires an accurate costing, pricing and regulation of parts of the service provision which takes place on a commercial basis. This suggests removing privileged access that SOEs/incumbents may have and compensating the companies adequately. The main points that emerge from the relevant OECD guidance and best practice bearing on accounting for public service obligations are as follows:

- OECD guidance recommends a sufficient degree of transparency and disclosure surrounding the use of public budgets provided as compensation for fulfilling public service obligations. The use of public resources should be subject to budget oversight and monitoring. (SOE Guidelines, Principles for Managing Ethics in the Public Service, Accountability and Transparency Guide, Market Mechanisms in Public Service Provision, Promoting Performance).
- In the context of balancing commercial and non-commercial priorities, OECD guidance recommends that SOEs should receive adequate compensation for the public policy priorities they are asked to undertake. They further recommend that compensation is disbursed and spent in a manner which can be accounted for separately. (SOE Guidelines, Accountability and Transparency Guide, Best Practices for Budget Transparency, Best Practice Guidelines).

on Off-Budget and Tax Expenditures.) These recommendations are applicable to incorporated and, in most cases, unincorporated units of government.

- OECD guidance recommends establishing reliable cost calculation methodologies that avoid, to the extent possible, cross-subsidisation practices. (SOE Guidelines, Accountability and Transparency Guide, Report on Universal Service Obligations.) In a competitive neutrality context, this is relevant in cases where SOEs or incumbents are expected to provide essential public goods alongside commercial activities.

## **2.5. Tax neutrality**

### ***Introduction to tax neutrality***

Public, private and third sector operators may face different tax treatment as a result of their ownership structure or legal form. This applies to a range of direct or indirect tax regimes including corporate/income taxes, value-added taxes (VAT), property taxes, and registration taxes. Difference in tax treatment has led to private sector complaints about unfair advantages faced by public sector businesses, as preferential tax treatment is tantamount to subsidies. Exemptions from certain tax requirements may impact on pricing<sup>27</sup> and can also influence government spending and investment decisions. For example with respect to VAT, governments may be less willing to outsource or incorporate public services if such services are subject to taxes and can otherwise be provided in-house tax-free.<sup>28</sup>

Governments are aware that to ensure a level playing field their businesses should face similar price signals as comparable private sector businesses. As a result, most incorporated SOEs, whether ordinary stock companies or statutory corporations generally face direct and indirect tax requirements that are similar to those of any other enterprises. Conversely, unincorporated business activity operated by general government is often not subject to indirect taxes.<sup>29</sup> In some cases, general government activities are also provided by non-profits entities that are not subject to corporate taxes. In most countries, it would be legally impossible or practically infeasible to impose corporate taxation on units of general government.

Under a competitive neutrality framework, tax neutrality implies that government businesses bear a similar tax burden as their private sector competitors. Given the sometimes subtle and indirect nature of exemptions, governments should consider a number of approaches to deal with taxation. These include:

- firmly enforced principles of non-discrimination for incorporated businesses;
- compensatory payments in lieu of taxation for unincorporated business activities; and/or,
- adjusting prices for government services to reflect increased cost of taxation.

In practice, tax neutrality approaches may involve a mix of those outlined above and their uses may depend on what is actually feasible. The benefits of one approach or another depends on the costs involved, the size of the business and the complexity of accounting and monitoring systems. These approaches and other issues concerning taxation are highlighted in instruments and good practices as outlined below.

### *OECD Instruments bearing on tax neutrality*

To the authors' knowledge there are no official instruments which bear directly on tax neutrality. For more related to cross border aspects of OECD instruments bearing on taxation refer to Box 2.16.<sup>30</sup>

### *Other good practices and related guidance*

#### *OECD International VAT/GST Guidelines: International Guidelines on Neutrality*

The **International Guidelines on Neutrality** (OECD, 2010) was approved in June 2011 for inclusion in the **OECD International VAT/GST Guidelines** (OECD, 2006). The guidelines are intended for use in a cross border context for what concerns the application of consumption taxes to international trade.<sup>31</sup> VAT neutrality, in and of itself, is not concerned with questions of ownership and a level playing field between public and private enterprises; it is concerned with neutrality in the sense that businesses should not bear the final tax burden. The principle of neutrality in the VAT Guidelines is defined as follows: "Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation".

The underlying concept of VAT neutrality is relevant for what concerns cross border activities of SOEs (for more on cross border aspects see Box 2.16). Interestingly enough, neutrality is more broadly reflected the philosophy of the existing tax rules in most countries. With this in mind, regardless of the international or domestic application of VAT, the Guidelines do share some insight relevant to this paper, it goes as follows: "VAT should also be administered in a neutral way, in the sense that it should not discriminate between similar businesses and businesses should not bear disproportionate or inappropriate compliance costs that could distort their economic decisions".<sup>32</sup> Examples of how different VAT treatment can affect economic decisions are discussed in the section below.

#### *Marketisation of Government Services – State-Owned Enterprises*

The Competition chapters of the OECD Regulatory Reform country reviews entitled, **Marketisation of Government Services – State-owned Enterprises**, analyse the use of policy instruments which aim to reinforce regulatory reforms *vis-à-vis* SOEs. The series includes country reviews of Finland (OECD, 2002) and Norway (OECD, 2003) where particular reference to tax policy and competitive neutrality has been made.

### Box 2.16. Cross border issues and SOEs

Concerns about a level playing field tend to grow considerably when SOEs operate in a cross-border context. These issues are only dealt with peripherally in this paper, but they do deserve mention. An on-going debate covers a number of interrelated, but distinct issues surrounding state-owned activities. First, the perception that foreign SOEs in some countries benefit from concessionary finance and indirect subsidies such as tax exemptions, allowing them not only to compete stronger but also to embark on series of corporate takeovers abroad. Second, governments have sometimes been accused of raising regulatory barriers unfounded in genuine public-interest objectives with the purpose of protecting their own enterprises. Third, while public procurement procedures are subject to rigorously enforced laws and regulations in virtually all OECD countries, SOEs are mostly found in sectors where complex contracts and multiple bidding criteria are common. Governments have been accused of benefiting from the complexities and gray zones to effectively give preferential treatment to national champions.

Cross-border issues arise relative to competitive neutrality in a number of other subject areas including trade, tax and investment policies:

- the political versus commercial objectives of investment vehicles and the applicability of the state immunity principle to state-owned commercial activities, which has been the subject of the **OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies** and internationally agreed **Santiago Principles**;
- the application of tax treaties to SOEs and sovereign wealth funds as considered by the revision of the **OECD Model Tax Convention**; and,
- the inclusion of competitive neutrality principles in international trade and investment agreements.

Sovereign Wealth Fund Sources: OECD (2008), Declaration On Sovereign Wealth Funds And Recipient Country Policies adopted in 2008; IWG (2008), Sovereign Wealth Funds: Generally Accepted Principles and Practices, “Santiago Principles, adopted in 2008 specifically address questions of neutrality under Principle 20, stating “The SWF should not seek or take advantage of privileged information of inappropriate influence by the broader government in competing with private firms”.

Source: OECD (2010), Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds (25 November 2009 – 31 January 2010). For more on the OECD Model Tax Convention see: [http://www.oecd.org/document/37/0,3746,en\\_2649\\_33747\\_1913957\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/37/0,3746,en_2649_33747_1913957_1_1_1_1,00.html)

The review of Finland discusses how exemptions from income tax can give rise to neutrality issues. The degree to which market distortions can arise depends whether the SOE is income tax exempt, and if so how rate of return targets are identified. An income tax exemption for SOEs could potentially result in lower than market prices, effectively undercutting competition. Where income tax exemptions exist, the actual discrepancy can be expressed in prices depending on whether state enterprises’ rate of return targets (refer to earlier Section 2.3) are expressed as an “after tax rate of return” on assets employed or if the state enterprise were set as “before tax rates of return”. A “before tax rate of return” would not necessarily influence prices so long as rate of return targets are comparable to private sector competitors, whereas the former has the potential to be non-neutral. This difference is further explained in Box 2.17. The review of Finland suggests that the most desirably outcome would be to repeal any income tax advantages afforded to SOE operating on a commercial basis to avoid any potential for competitive distortions.<sup>33</sup>

### Box 2.17. Before and after tax rate of return targets

A partial exemption from income tax has the potential to be non-neutral in competition between state and private enterprises. It is a *potential* distortion because the effect on prices charged by state enterprises, *vis-à-vis* those charged by private competitors will depend on how rates of return targets are expressed:

- If a state enterprise faces and achieves a rate of return target that is expressed as an after tax rate of return on assets employed, which is comparable to its private competitors, then that state enterprise will have a significant competitive advantage if its business is mainly directed at sales to state agencies (where sales to state agencies is income tax exempt). Assuming its costs were comparable to private sector competitors the state enterprise could charge lower prices and still achieve the after tax rate of return targets since it would not pay tax. The after tax nature of the rate of return target makes taxation payments a cost of doing business so far as calculating the rate of return target is concerned.
- Alternatively, if the same state enterprise were to set a before tax rate of return target comparable to its private sector competitors, then the tax exemption should not flow through to lower prices. In this event, tax is not a cost of doing business so far as calculating the rate of return target is concerned – tax is then simply one mechanism by which a return is made to the state.

Excerpt from: OECD (2003), Finland, p.16.

Other forms of tax discrimination discussed in the Finnish review relate to special taxes (used to limit access to areas of importance for public service obligations).<sup>34</sup> The findings of the review indicate that special taxes can be used to over-compensate for the disadvantages associated with providing public services in unprofitable areas, further bolster the position of the SOE incumbent, and often result in deterring competition altogether. A number of alternative and more neutral options are considered in the case of the Finnish postal sector, including:

- maintaining special taxes but putting in place a mechanism that would link the rate of tax and revenue raised, the tax revenue should be paid to the SOE incumbent;
- abolishing special taxes altogether; or,
- abolishing special taxes but applying a small turnover tax applicable to all operators (including the SOE incumbent); this would be used to pay the SOE incumbent for the net cost of the universal service obligation (this requires careful calculation of the cost of the universal service obligation as discussed in Section 2.4).<sup>35</sup>

The review of Norway discusses the VAT incentive against outsourcing which more generally results from VAT exemptions. In Norway (as is generally the case in most countries), there is a general obligation to pay VAT on both goods and services; the own production of a business for internal use is not taxable under VAT (since there is no transaction).<sup>36</sup> Since VAT exempt businesses, in this case public sector bodies, cannot recover the VAT on their inputs from an external provider, the VAT becomes a cost and hence a disincentive to outsource. According to the Norway review, the exempt status of public bodies has led some municipalities to favour in-house provision of goods and services in order to avoid the cost of VAT. Even if outsourcing could have produced more efficient results, the difference in costs due to the VAT made private sector offers relatively less competitive. One proposed remedy to ensure equal consideration of both in-house and outsourced provision is to enact a system of VAT compensation for all municipal purchases.<sup>37</sup>

### ***Conclusions on tax neutrality***

The equal tax treatment of public and private business activities is important for competitive neutrality. Where government businesses are incorporated along the lines suggested in the SOE Guidelines this is usually not an issue. However, careful consideration should be made in order to ensure government is not provided any perverse incentives to avoid paying taxes. For example, government should generally not favour purchasing goods and services from itself in order to avoid taxation. The following points emerge from OECD guidance that bear on tax neutrality:

- In cross-border trade, businesses in similar situations carrying out similar transactions should be subject to similar levels of value added taxation (OECD International VAT/GST Guidelines – International Guidelines on Neutrality). This is one of the relatively few relevant pieces of OECD guidance to deal specifically with the cross-border aspect of neutrality.
- In cross-border trade where specific administrative requirements of foreign businesses are deemed necessary, value added tax should be administered in a way which does not bear disproportionate or inappropriate compliance costs for business (OECD International VAT/GST Guidelines – International Guidelines on Neutrality).
- In cases where tax rules cannot be evenly applied, OECD guidance recommends transparency surrounding such tax exemptions in order to determine and rectify possible advantages associated with them (Marketisation of Government Services).

### **2.6. Regulatory neutrality**

#### ***Introduction to regulatory neutrality***

Regulatory quality is essential to improve the efficiency of the public sector, to correct market failures (especially in sectors that underwent privatisation or were increasingly opened up to competition) and to level the playing field among all types of business (especially among small and medium-sized firms). This has led many governments to undertake regulatory reform across all levels of government to eliminate outdated regulations, simplify requirements, reduce regulatory burdens, and lower compliance costs. Regulatory reform has lowered the cost of doing business in many economies and has been a key driver in promoting open and competitive markets, economic efficiency and consumer welfare.

In cases where business activity remains in the hands of the state, regulatory reforms have also aimed at requiring government businesses to operate, to the largest extent feasible, in the same regulatory environment as private enterprises. In the context of competitive neutrality, there are some areas where this has been an issue. For example, government-controlled financial sector activities are often identified as an area where state-owned businesses may sometimes be subject to a lighter regulatory approach. Further problems arise when unincorporated government entities are involved in undertakings since such entities generally enjoy regulatory and other advantages due to their integration with the executive powers. Some of these advantages may also apply to statutory corporations. According to the national context, areas for non-neutrality may include:

- exemptions from compliance with disclosure or new requirements (i.e. environmental regulations);
- exemptions from restrictive business practices laws;

- exemptions from sovereign immunity laws;
- exemptions from bankruptcy laws;
- exemptions from building permit regulations or from zoning regulations (not least where municipally owned businesses are concerned);
- preferential access to land; and/or
- uneven regulatory burden.

Governments have also been accused of erecting regulatory barriers unfounded in genuine public-interest objectives with the purpose of protecting their own enterprises (i.e. to protect national champions). For example, confronted with new environmental regulations, incumbent companies have sometimes lobbied to obtain grandfather clauses. This can create significant cost asymmetries between incumbents and entrants with considerable harm to competition.

In general, regulation aims to promote competition, regulatory neutrality can be provided in principle by governments enforcing a non-discrimination and transparency policy – especially if commercial and non-commercial priorities are explicitly identified and accounted for separately. However, when this is not the case, differences in regulatory treatment must be made explicit, especially in sectors with natural monopoly tendencies. An SOE's legal status, as established by corporate law, charter or statutory authorisation, should clearly identify its relationship to the government, any exemptions from legal or regulatory frameworks, and any special privileges, for the benefit of other economic actors with which it interacts. Furthermore, an assessment must be made of the benefits that the government business obtains from its advantages, on the basis of which compensatory payments are made. Some of these points are reflected in OECD instruments, recommendations and good practices which address aspects of regulatory neutrality in general terms, or in terms of market regulations.

### ***OECD Instruments bearing on regulatory neutrality***

#### *SOE Guidelines*

The **SOE Guidelines** address the issue of regulatory neutrality in a number of ways. First, they underline the importance of separating the role of market regulator with ownership functions of SOEs.<sup>38</sup> This is particularly relevant in newly liberalised industries, such as currently the network industries. The recommendations call for full administration separation of responsibilities as a prerequisite for levelling the playing field between SOEs and private companies.

Secondly, they call for the removal of exemptions to the application of general laws and regulations to SOEs. The annotations to Guideline I.B. specifically recommend changing the legal form of SOEs (Box 2.18). This recommendation is consistent with competitive neutrality principles in that it suggests, first and foremost, streamlining the operational form of SOEs, thus ensuring that its relation to the government is made explicit. However, it goes further by suggesting two options if its legal form cannot be changed: a) specific regulations should extend their validity or coverage to SOEs; or b) SOEs should voluntarily fulfil requirements from these specific regulations, particularly concerning disclosure requirements. The second option is particularly useful in the case of non-incorporated government undertakings whose commercial and non-commercial activities may not be easily separated, and thus voluntary fulfilment of regulatory requirements for governmental

undertakings could be one way to level the playing field with the private sector in the absence of any formal requirements.

Guideline I.D implies that legal and regulatory exemptions should be avoided in order to prevent market distortions. In particular, exemption from competition law is cited as an example. Indeed, application of competition law would address a number of sources of non-neutrality, but the limit of the Guidelines rests in the fact that they are less applicable to cases where government undertakings are operated by non-incorporated government departments. The Guidelines do not provide specific recommendations on how to address such differences in regulatory or legal treatment, but they stress that stakeholders and competition should have the right to redress when their rights have been violated (which may or may not extend to cases where neutrality has been violated).

#### Box 2.18. Relevant SOE Guidelines

**Guideline I.B. Governments should strive to simplify and streamline the operational practices and the legal form under which SOEs operate. Their legal form should allow creditors to press their claims and to initiate insolvency procedures.**

Annotations:

*“If the change of the legal forms of SOEs is too difficult, other options could be to streamline SOEs’ operational practices, make some specific regulations more inclusive, i.e. extending their validity or coverage to SOEs with specific legal forms, or ask SOEs to voluntarily fulfil requirements from these specific regulations, particularly concerning disclosure requirements.”*

**Guideline I.D. SOEs should not be exempt from the application of general laws and regulations. Stakeholders, including competitors, should have access to efficient redress and an even-handed ruling when they consider that their rights have been violated.**

Annotations:

*“Experience has shown that in some countries SOEs may be exempt from a number of laws and regulations, including in a few cases, from competition law. SOEs are often not covered by bankruptcy law and creditors sometimes have difficulties in enforcing their contracts and in obtaining payments. Such exemptions from the general legal provisions should be avoided to the fullest extent possible in order to avoid market distortions and underpinning the accountability of management.”*

#### *Recommendation of the Council on Improving the Quality of Government Regulation*

The 1995 **Recommendation on Improving the Quality of Government Regulation** is aimed at ensuring policy effectiveness and economic efficiency through high quality recommendation. While the Recommendations remain current, it is followed by two other instruments enacted in 1997 and 2005 which build on its application and coverage (see sections below). The Recommendation’s *raison d’être*, among others, is to remove barriers to competition resulting out of regulations. While the Recommendation is not intended to address specifically the activities of state-owned enterprises nor government business undertakings, they do touch upon a few areas of relevance. An integral part of the Recommendations is a Reference Checklist for Regulatory Decision-making which addresses a number of points bearing on competitive neutrality.

The Checklist’s Question two, calls for “re-evaluating the need for government intervention” and recommends that the government “establish a process for systematic and periodic review of the need

for existing regulations” (Box 2.19). The presence of competition or the potential for competition can change depending on market circumstances or conditions which have changed since regulations were adopted. The justification for state intervention – for example in the form of regulatory exemptions for government undertakings – too, can change and should be re-evaluated periodically.

Under explanatory text to question four, the Checklist calls for “legal consistency” and consistency with international norms and agreements. It recommends that proposals for regulation ensure compliance with legal principles such as equality before the law. The equality before the law principle can be interpreted in the context of competition: whether or not all enterprises, regardless of their ownership or nationality, are subject to the same laws and regulations. This principle can apply to either advantages or disadvantages in the face of the law. Furthermore, it touches upon cross border issues, such as regulations which may be perceived to be discriminatory or give preferential treatment to national champions or incumbents.

#### **Box 2.19. Questions from the OECD Reference Checklist for Regulatory Decision-making**

##### **Question 2: Is Government Action Justified?**

*“Re-evaluating the need for government intervention is particularly important when governments review existing regulations, since conditions may have changed since regulations were adopted. To compensate for the tendency for regulations to become outdated and inconsistent with current needs, governments should establish processes for systematic and periodic review of the need for existing regulations.”*

##### **Question 4: Is there a Legal Basis for Regulation?**

*“A key question to ask is whether the regulation is compatible with existing legislation, including international norms or agreements. New regulations must comfortably co-exist with existing regulations; to that end, regulators should examine whether other regulations should be repealed or amended to ensure legal consistency.”*

*“Administrators may also need to examine regulatory proposals for compliance with obligatory legal principles such as certainty, proportionality, and equality before the law.”*

##### **Question 6: Do the Benefits of Regulation Justify the Costs?**

*“Regulations with larger effects might justify, in addition to consultation, more precise forms of benefit-cost analysis or various kinds of market analyses of effects on competition, international competitiveness, or technological innovation.”*

Consistent with recommendations for structural separation, question six of the Checklist recommends a clear assessment of costs and benefits for the introduction of new regulations, and specifically recommends that for regulations with larger effects, a cost-benefit analysis should also include market analyses of effects on competition. This recommendation is applicable especially in cases where sector specific regulations may serve to add additional layers of regulation to further lock-in the role of incumbents.

#### *Report and Recommendations on Regulatory Reform*

The 1997 **Report on Regulatory Reform and its Recommendations** follows up on the 1995 Recommendation of the Council. The Recommendations defines “good regulation” as policy with clearly identified goals, and which reinforces transparency and non-discrimination. The annotations to Recommendations 1, 3 and 6 highlight the importance of avoiding market distortions and further recommend that regulatory reforms should be compatible with competition, trade and investment-

facilitating principles at the domestic and international levels (Box 2.20). This reinforces maintaining a level playing field and respecting investment principles such as national treatment and non-discrimination which are relevant in a cross-border context. The recommendations recognise the value of public consultation as a means to improve market access and increase regulatory transparency (Recommendations 3 and 6).

The annotations to the first and fourth Recommendation stress the application of competition policies and the role of competition authorities in managing exemptions from national competition laws. In particular, the recommendations identify the risks associated with self-regulation and voluntary approaches, such as “undue influence by private interests, barriers to competition and lack of transparency and accountability”. All of these risks are also applicable to competitive neutrality, and thus an important recommendation can be taken away in that self-regulation and voluntary approaches to maintaining regulatory neutrality should also be balanced with mechanisms to ensure compliance and enforcement. The recommendations highlight, based on OECD member country experiences, that one way to ensure compliance and enforcement is to place responsibility for reform at the ministerial level or higher and to make reform proposals available to the public and media in order to increase public attention (Recommendation 1).

The recommendations further encourage competition authorities to advocate reform and “vigorously” enforce laws, especially in cases where anti-competitive practices such as cartel conduct, abuses of dominant positions and anti-competitive mergers take place (see Section 2.8 on public procurement for further discussion of anti-competitive practices). These recommendations are fully supportive of competitive neutrality, especially in specific sectors such as in energy, utilities, transport, and communications where limited applicability of competition laws are widespread due to their natural monopoly characteristics and due to the nature of specific regulations on public service obligations which can lock in incumbents.<sup>39</sup>

These issues are further elaborated in Recommendation 5 which calls for reforming or removing economic regulations that impede competition. These regulations take many forms at various levels of government such as legal monopolies that block competition in specific sectors, or other types of restrictions such as quotas in business licenses, which can impede new market entrants.

The second Recommendation echoes the 1995 Regulation Recommendation (previous section) in advising a periodic review of government regulation. The 1997 Recommendation go further by suggesting “life-cycle management of regulations” which promotes continuous review of the relevance of regulations throughout through automatic mechanisms such as sun setting. Sunset clauses set deadlines for the end of specific regulatory exceptions and benefits that may be enjoyed by state-owned enterprises or incumbents.

Finally, the Recommendations call for reforming non-regulatory policy areas which can distort competition (Recommendation 7), in particular it highlights the “*Review non-regulatory policies, including subsidies, taxes, procurement policies, trade instruments such as tariffs, and other support policies, and reform them where they unnecessarily distort competition*”.

#### *OECD Guiding Principles for Regulatory Quality and Performance*

The **OECD Guiding Principles on Regulatory Quality and Performance** (OECD, 2005), maintain the original seven principles of the 1997 Recommendations (Box 2.20), but place greater attention to market openness and competition policy for network utilities. They were endorsed by Council in 2005 after being approved by the Public Governance (via the Working Party on Regulatory Management and Reform), Trade and Competition committees.

Above and beyond the issues analysed in detail above, the 2005 Guiding Principles specifically address competitive neutrality and state-ownership under Guiding Principle five which recommends, “Periodically review the state ownership stake or financial interest in undertakings with market power and whether they unduly impair competition or impede pro-competitive reforms”.

**Box 2.21. Relevant Principles and annotations from the 1997 Policy Recommendations for Regulatory Reform/2005 Guiding Principles for Regulatory Quality and Performance**

**1. Adopt at the political level broad programmes of regulatory reform that establish clear objectives and frameworks for implementation.**

Annotations:

*“Good regulation should...minimise costs and market distortions...and be compatible as far as possible with competition, trade, and investment-facilitating principles at domestic and international levels.”*

**2. Review regulations systematically to ensure that they continue to meet their intended objectives efficiently and effectively.**

Annotations:

*“Governments should implement the concept of life-cycle management of regulations...automatic mechanisms, such as sun setting, are used in some countries to ensure that periodic review takes place...”*

**3. Ensure that regulations and regulatory processes are transparent, non-discriminatory and efficiently applied.**

Annotations:

*“Ensure that procedures for applying regulations are transparent, non-discriminatory, contain an appeals process, and do not unduly delay business decisions.”*

**4. Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy.**

Annotations:

*“Eliminate sectoral gaps in the coverage of competition laws, unless evidence suggests that compelling public interests cannot be served in better ways.”*

*“Enforce competition laws vigorously where collusive behaviour, abuse of dominant position, or anticompetitive mergers risk frustrating reform.”*

*“Provide competition authorities with the authority and capacity to advocate reform.”*

**5. Reform economic regulations in all sectors to stimulate competition, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.**

Annotations:

*“Review as a high priority those aspects of economic regulations that restrict entry, exit, pricing, output, normal commercial practices, and forms of business organisation.”*

*“Promote efficiency and the transition to effective competition where economic regulations continue to be needed because of potential for abuse of market power. In particular: (i) separate potentially competitive activities from regulated utility networks, and otherwise restructure as needed to reduce the market power of incumbents; (ii) guarantee access to essential network facilities to all market entrants on a transparent and non-discriminatory basis; (iii) use price caps and other mechanisms to encourage efficiency gains when price controls are needed during the transition to competition.”*

**6. Eliminate unnecessary regulatory barriers to trade and investment by enhancing implementation of international agreements and strengthening international principles.**

### *Recommendation of the OECD Council on Competition Assessment*

The 2005 Guiding Principles are further complemented by a **Recommendation of the OECD Council on Competition Assessment** (OECD, 2009). The Recommendation provides a methodology (“competition assessment”) to identify and evaluate policies which may unduly restrict competition. The Recommendations were endorsed by Council in 2009 and are complemented by a Competition Assessment Toolkit developed by the Competition Committee (Box 2.21).

Notably, the Recommendations argue, “...that public policies that unduly restrict competition may be reformed in a way that promotes market competition while achieving public policy objectives”. As such the Recommendations acknowledge that remedies are available to level the playing field. In performing a competition assessment, the recommendations stress that governments should assess the policies that limit “the incentives of market participants to behave in a competitive manner”. The recommendations define “market participants” to include, among others, “government enterprises engaged in supplying or purchasing goods or services”. Thus, they also hold government enterprises accountable to behave in a competitively neutral manner in the market.

The Recommendations do not provide any further advice on how to remedy non-neutral behaviour, but they suggest that a competition assessment should be conducted in association with competition bodies or experts, and that the assessment should be integrated in the policy-making process.

#### **Box 2.21. Competition Assessment Toolkit**

The OECD’s Competition Assessment Toolkit provides policymakers with an analytical framework within which to examine whether legislation raises competition concerns. Although the majority of regulations are unproblematic in competition terms, where potential restraints exist – because the regulation limits the number or range of suppliers, limits the ability of suppliers to compete, reduces the incentive of suppliers to compete and/or limits the choices and information available to customers – the competition assessment process assists regulators and legislators in mitigating or avoiding the competition harm. It does so by aiding them in identifying possible alternatives that might reduce or eliminate competition problems while continuing to achieve the desired policy objectives.

As a first step, the method employs a set of threshold questions, a “Competition Checklist”, which indicates when proposed laws or regulations may have significant potential to do harm. For example, a proposal is likely to limit the number or range of suppliers if it:

- grants exclusive rights for a supplier to provide goods or services;
- imposes a license, permit or authorisation requirement for operation;
- limits the ability of some types of suppliers to provide a good or service;
- significantly raises cost of entry or exit by a supplier; and/or
- creates a geographical barrier to the ability of companies to supply goods, services or labour or invest capital.

Most proposals pass this initial screening process without raising any competition concerns. Where a potential restraint is identified, the assessment mechanism mandates more comprehensive scrutiny. A thorough competition assessment includes: (1) clearly identifying policy objectives; (2) stating alternative regulations that would achieve the policy objectives; (3) evaluating the competitive effects of each alternative; and (4) comparing the alternatives.

## *Recommendation of the Council on Competition Policy and Exempted or Regulated Sectors*

The **Recommendation on Competition Policy and Exempted or Regulated Sectors** (OECD, 1979) apply to regulated firms which may be totally or partially exempted from restrictive business law practices in order to fulfil both commercial and non-commercial objectives. It recommends that governments undertake review of regulatory regimes and exemptions from restrictive business practices law. Where regulations remain desirable to achieve public policy objectives or where SOEs are involved, competition based approaches are recommended to alleviate adverse effects which may result from excessive regulation. Special consideration should be given to SOEs which benefit from certain exemptions due to their public policy objectives; the recommendations suggest that regulations should not impede competition.<sup>40</sup>

Further to the Council Recommendation, there are a number of sector-specific reviews which have examined the role of exempted or regulated sectors. These reviews have covered the telecommunications (2002), public utilities (2001), rail transport (1998), waste management (2000), and postal services (1999) markets. The reviews highlight the importance of market regulation in order to reduce barriers to entry and foster competition. One of the key factors in ensuring the effectiveness of market regulation is whether or not there is a level playing field between public and private actors (Box 2.22).<sup>41</sup>

### **Box 2.22. OECD Council Recommendation on Broadband Development**

Nearly all broadband strategies in OECD countries recognise and emphasise the role of competition in the broadband market, this is reflected in the **OECD Council Recommendation on Broadband Development** (OECD, 2004), endorsed in 2004. The Recommendation calls on Member countries to implement a set of policy principles to assist the expansion of broadband markets, promote efficient and innovative supply arrangements, and encourage effective use of broadband services. The recommendation relates to competitive neutrality in that it recommends effective competition through transparent and non-discriminatory market policies, and specifically promotes broadband policies that balance both public and private sector initiatives.

Relevant excerpts from the Recommendation are cited as follows:

*“Effective competition and continued liberalisation in infrastructure, network services and applications in the face of convergence across different technological platforms that supply broadband services and maintain transparent, non-discriminatory market policies”.*

*“Recognition of the primary role of the private sector in the expansion of coverage and the use of broadband, with complementary government initiatives that take care not to distort the market”.*

OECD (2004), OECD Broadband Recommendation. Also see: OECD (2001), “Broadband Infrastructure Deployment: The Role of Government Assistance”, OECD (2003), “Universal Service Obligations and Broadband” and “Universal Service and National Broadband Plans” (2011).

## *Policy Framework for Effective and Efficient Financial Regulation*

Government-controlled financial sector activities are typically identified as an area where state-owned businesses may be subject to a lighter regulatory approach. The **Policy Framework for Effective and Efficient Financial Regulation** (OECD, 2009) approved in 2009, intends to set guidelines for establishing a sound policy and regulatory framework for the financial sector. In what concerns competitive neutrality, the recommendations recognise that the nature of financial regulation should be consistent and neutral irrespective of ownership, product, institution, sector and markets

[Principle III.C (e)]; on an international dimension financial regulation should remove barriers to level the playing field across countries [Principle II.C (j)], (Box 2.23).

The recommendations (Principle V) also call for periodic review of financial regulation to ensure consistency with the rapid evolution of the financial system and to review the framework for government intervention. This can be applied to the case of government-controlled or owned financial institutions, where the framework for government financial regulations, setting out conditions for continued government stake or ownership, should be reviewed on a periodic basis to ensure a level playing field.

#### **Box 2.23. Principle III.C and Principle V on Financial Regulation**

##### **Principle III.C: Policy Instruments – Principles of Financial Regulation**

###### **e) Consistent and Competitive Neutrality:**

*“Financial regulation should be applied in a consistent, “functionally equivalent” manner (i.e. neutral from a product, institutional, sectoral, and market perspective so that similar risks are treated equivalently by regulation). With the growth of financial groups, and convergence of financial sectors and markets, more consistent, co-ordinated, and integrated forms of regulation should be adopted across: (i) products, services, sectors, systems, and markets; and (ii) financial firms and groups.”*

###### **j) Promotion of open, competitive, and safe markets through the establishment of a level playing field and removal of unnecessary duplication, burdens, conflicts and barriers across countries:**

*“Financial regulation should ensure a level playing field and not lead to unnecessary duplication, burden, conflict, or barriers across countries, and thereby promote open, competitive, and safe markets.”*

##### **Principle V: Review**

*a) The framework for government intervention and regulation...should be adjusted and amended as necessary to ensure: (i) continued relevance and appropriateness of stated policy objectives and the weightings attached to them; and (ii) the effectiveness and efficiency of the policy instruments and system of institutions used to achieve them.*

*b) At minimum, the framework for government intervention and regulation should be subject to a comprehensive review on a periodic basis (e.g. every five to eight years).*

#### ***Other good practices and related guidance***

##### ***APEC-OECD Integrated Checklist on Regulatory Reform***

The **APEC-OECD Integrated Checklist on Regulatory Reform** (OECD/APEC, 2005) is the result of an agreement to develop an APEC-OECD Co-operative Initiative on Regulatory Reform. The Checklist was endorsed by the executive bodies of APEC and the OECD in 2005. The Checklist is a voluntary tool that member economies may use to self-evaluate their respective regulatory reform efforts; it is based on the accumulated knowledge of the **OECD Regulatory Reform Principles** (1995, 1997 and 2005) and the **APEC Principles to Enhance Competition and Regulatory Reform**.

Both the OECD and APEC principles give importance to regulatory reform in order to improve regulatory quality and competition, and avoid unnecessary economic distortions. They also share core values such as transparency, non-discrimination, and accountability. The two sets of Principles,

integrated, as they are presented in the Checklist, are mutually supportive in their approach and draw upon other key issues which have been identified by both organisations.

The Checklist explicitly refers to competitive neutrality and adopts the commonly held definition that is used in this paper (Box 2.24). The scope of the principle, as addressed in the Checklist, is horizontal in that it covers a wide scope of areas where neutrality can be put into question. The recommendation goes beyond regulatory policy, as the Checklist recognises the multi-disciplinary approach needed to address non-neutrality especially in cases where regulatory bodies may have less scope for action. It also emphasises the role of competition law and policies.<sup>42</sup>

**Box 2.24. Competitive Neutrality addressed in the APEC-OECD Integrated Checklist on Regulatory Reform**

**Checklist:**

To what extent are measures taken to neutralise the advantages accruing to government business activities as a consequence of their public ownership?

**Annotations:**

*“Under the principle of competitive neutrality, government business undertaking business activities should not have competitive advantages or disadvantages relative to their private sector competitors simply by virtue of their government ownership. Competitive neutrality reduces resource allocation distortions and improves competitive processes. Both effects promote economic efficiency. A competitive neutrality policy prescribes a range of measures, including neutralising advantages that may accrue to public business in the areas of debt financing, preventing anti-competitive cross-subsidisation between regulated and competitive activities, regulation and taxation and requiring these businesses to earn a commercial rate of return. Competitive neutrality does not imply that government businesses cannot be successful in competition with private businesses, nor that government has no role in fulfilling public service needs or other special responsibilities. Government businesses may achieve success as a result of their own merits and intrinsic strengths, but not as a consequence of unfair advantages flowing from government ownership.”*

*Recommendation of the Council on Regulatory Policy and Governance*

The Draft **Recommendation of the Council on Regulatory Policy and Governance** (OECD, 2012) covers regulatory policy, management and governance and is whole-of-government instrument that is intended for use by sectoral ministries and regulatory agencies. It was approved by Council in March 2012 following a process of consultation. The Recommendation aims to expand the coverage of existing OECD instruments on regulatory reform and management adopted since 1995 (in particular the **1995 Recommendations**, the **1997 Report and Recommendations**, the **2005 Guiding Principles**, and the **2005 APEC-OECD Integrated Checklist**). The Recommendation explicitly mentions competitive neutrality, addressing the legality and fairness of regulations, and in particular referring to the role of independent regulatory agencies. The recommendations apply in cases where regulatory and other functions of government are not clearly separated from commercial undertakings either at the national or sub-national level (Box 2.25, recommendations 4.6, 7.3 and 11.8). The separation of regulatory functions is a key component of corporatisation and commercialisation processes and is coherent with the recommendations of the SOE Guidelines.<sup>43</sup> Other references to competitive neutrality are not made explicit, but they do underline use of cost-benefit analysis as a means to assess restrictions on competition, essentially recommending that competition should not be restricted in the name of public service interests (recommendation 4.6).

**Box 2.25. Annotations to the Draft Recommendation of the Council  
on Regulatory Policy and Governance**

**Recommendation 7.3 on organisation of regulatory agencies:**

*“Independent regulatory agencies should be considered in situations where: Both the government and private entities are regulated under the same framework competitive neutrality is therefore required.”*

Other references to competitive neutrality included in annotations include:

**Recommendation 4.6 on regulatory impact analysis (RIA):**

*“Ex ante assessment policies should indicate that regulation should seek to enhance, not deter, competition and consumer welfare, and that to the extent that regulations dictated by public interest benefits may affect the competitive process, authorities should explore ways to limit adverse effects and carefully evaluate them against the claimed benefits of the regulation. This includes exploring whether the objectives of the regulation cannot be achieved by other less restrictive means.”*

**Recommendation 11.8 on regulatory management capacity at sub-national level:**

*“Prevent conflicts of interests through clear separation of the roles of sub-national governments as regulators and service providers.”*

***Conclusions on regulatory neutrality***

Regulatory neutrality not only deals with the general business environment issues (i.e. business laws and regulations) it is also concerned with market regulations (i.e. sector specific). Concerning the general business environment, in most OECD economies, incorporated SOEs are subject to the same/similar regulatory treatment as private businesses. Where SOEs are created according to corporate charter or statutory authorisation, or where commercial activities remain integrated with general units of government, certain regulatory exemptions may be afforded by law which may not be consistent with competitive neutrality. OECD guidance covers the following issues concerning regulatory neutrality:

- Where regulatory exemptions apply due to the SOEs legal form, OECD Guidance recommend incorporating SOEs according to company law (along the lines recommended in Section 2.1) making it subject to the same regulatory treatment as private businesses. Where this is not possible, the validity of regulations could be extended to the SOE; or could be applied on a voluntary basis. (SOE Guidelines, Draft Recommendation of the Council on Regulatory Policy and Governance.)
- OECD guidance recommends that government participation in regulated markets be evaluated on a periodic basis. Such recommendations are particularly relevant for regulated markets where SOEs or incumbents retain certain monopoly rights. (Recommendation on Competition Policy and Exempted or Regulated Sectors, Recommendation on Improving Quality of Government Regulation, Report and Recommendations on Regulatory Reform, Guiding Principles on Regulatory Quality and Performance, Recommendation on Competition Assessment.)

- Concerning financial regulation, OECD guidance on Effective and Efficient Financial Regulation recommends that regulations should be consistent and neutral irrespective of ownership, institution, sector, and markets. This applies equally to government-controlled or owned financial institutions.
- OECD guidance recommends that a combination of regulatory and non-regulatory measures may be necessary to neutralise any advantages or disadvantages that may accrue due to ownership. Competition, trade and investment authorities are all identified as having a role in enforcing competitive neutrality. (APEC-OECD Integrated Checklist on Regulatory Reform, OECD Guiding Principles on Regulatory Quality, Report and Recommendations on Regulatory Reform.)

## 2.7. Debt neutrality and outright subsidies

### *Introduction to debt neutrality*

Debt neutrality implies that SOEs and other government businesses shall pay the same interest rate on the debt obligations they incur as a private enterprise in like circumstances. It is straightforward for governments to ensure that the commercial entities they control do not benefit from subsidised finance – not least since the subsidies would normally be provided by government itself. State aids and subsidies directed to inefficient firms distort firms' behaviour, as they subject them to softer budget constraints than their non-subsidised rivals. Government loans provided at below market interest rates or against collateral or securitisation that would not be acceptable under purely commercial terms, are tantamount to direct grants and can have the same distortive outcome.<sup>44</sup>

Moreover, subsidies and state aids can result in other perverse outcomes. State aids serve to improve the receiving firm's cash flow, enhances its balance sheets, and builds its assets in a way that may allow the firm to raise additional debt financing or equity capital. It also adds to a perceived lower default risk, which in turn may result in cheaper finance in the market place than would be available to private operators engaged in similar activities. SOEs may have access to favourable credit rates or enjoy government-provided credit guarantees which reduce their cost of borrowing and enhance their competitiveness *vis-à-vis* their privately-owned rivals. Preferential access to credit can result in crowding out private sector borrowers.

Even in cases where SOEs do not explicitly enjoy preferential credit rates or possess government guarantees, the market generally views SOEs as enjoying implicit guarantees from the government. This perception is reinforced if there is indeed a history of government-backing (e.g. general government taking on debt obligations of an SOE which cannot pay). Research has shown that politically-connected firms are more likely to be the beneficiaries of a government bailout. In emerging markets, this is further amplified.<sup>45</sup> In some countries, credit is extended by state-owned banks, potentially posing additional problems in terms of conflict of interest. Support from the political apparatus does not always result in the most efficient outcomes as public enterprises may not feel the pressures of market discipline and in some cases are not subject to bankruptcy laws (or are perceived not to be).<sup>46</sup>

Regardless of the type of financial support, ranging from cheaper access to financing, preferential credit conditions, outright subsidies or explicit/implicit guarantees, SOEs may benefit from significant cost savings and can more easily expand their business operations than their private sector competitors. These issues are reflected in the OECD instruments and good practices featured in sections below.

## *OECD Instruments bearing on debt neutrality*

### *SOE Guidelines*

The **SOE Guideline I.F** explicitly states that SOEs should access finance according to “competitive conditions” and on “purely commercial grounds”. These points are compatible with competitive neutrality, in the sense that public enterprises should not be afforded preferential treatment.

In order to avoid departure from a level playing field, the annotated text to the guideline suggests a number of good practices to ensure more fair treatment of SOEs. To summarise, these include:

- a clear distinction must be made between the SOE, the state and creditors;
- the state should not give an automatic guarantee in respect of SOE liabilities;
- there should be fair practices with regard to the disclosure and remuneration of state guarantees;
- SOEs should be encouraged to seek other sources of financing such as equity;
- put in place mechanisms to avoid conflicts of interest between SOEs and state-owned banks/financial institutions; and,
- grant credit on the same terms as the private sector.

### *Other good practices and related guidance*

#### *Regulating Market Activities by the Public Sector*

The Competition paper entitled, **Regulating Market Activities by the Public Sector** (OECD, 2004) raises the issue of moral hazard concerning guaranteeing SOE debt. It points out, based on the experience of Mexico, that SOEs whose debt is backed by the government, will be at an advantage to the private sector in that they’ll have “deeper pockets” to invest and manage their income – and not necessarily more efficiently; this will also afford them discretion in practicing cross-subsidisation.<sup>47</sup> Without mechanisms to factor in the actual cost of borrowing, an SOE faces much less pressure than its private sector counterparts to offset its spending with reasonable returns.

The paper draws upon good practice implemented in Australia with the aim of levelling the playing field between private and public sector businesses for what concerns debt neutrality. The Australian model relies on debt rating agencies to provide a credit evaluation of government businesses under a counterfactual assumption of private ownership. The good practice requires SOEs to pay debt guarantee fees to offset any cost advantages that stem directly from its ownership. Where there are no existing guarantees, the neutrality fees could also take into account *perceived* government guarantees on debt. According to the report, the size of the debt guarantee would vary depending on changes in the debt market.

Depending on the size of the business and the type of borrowing, the government could instead adjust the cost of debt provided through the public purse to reflect market costs of borrowing. This would not necessarily affect the preferential treatment afforded to the SOE (e.g. if private lenders

would treat an SOE leniently because of its ownership), but it would at least reflect the actual cost of borrowing for an equivalent private sector entity.

According to the country experiences covered by the report, putting into place mechanisms to account for neutrality adjustments are not implemented quickly because of lack of know-how. This is especially the case for smaller SOEs or units of government which may not have the expertise to implement such reforms.

#### *Roundtable on Competition, State Aids and Subsidies – EU Anti-trust and State Aid Discipline*

The proceedings from the 2010 **Roundtable on Competition, State Aids and Subsidies** (OECD, 2010) shed light on a number of issues concerning debt neutrality. The report points out that, according to the EC experience, the only acceptable circumstances when the State should intervene is to correct market failures. And even when it does, it should grant loans at market rates, against collateral that is required by the market. Furthermore, guarantees are acceptable if granted on the same conditions to the private sector. European law, as described in the Roundtable proceedings, has devised a number of “tests” (“private investor”, “private creditor” and “private vendor” test) to assess whether the State has behaved like a market participant. The general consensus, however, is that state aids tend to make the playing field uneven.<sup>48</sup>

#### *Competition and Financial Markets (Volume 2)*

The 2009 volume of proceedings from the **Competition and Financial Markets** Roundtable (OECD, 2009) reiterates most of the issues described in the sections above concerning the role of direct and implicit government guarantees, and favourable credit conditions for SOEs. But it goes further to discuss the role of state-owned banks. First, state-owned banks, being themselves SOEs, are subject to the same favourable treatment in that they could possibly get cheaper access to capital thanks to lower default risks compared to privately-owned banks.

Another angle concerning state-owned banks is their relationship with SOEs and the government. As mentioned in the introduction, and echoed by the SOE Guidelines, state-owned banks could be under pressure to lend to companies according to political priorities, rather than purely commercial criteria. The report provides no proxies to measure these distortions, but it comes up in a number of national contexts, such as the Netherlands and the UK, as a barrier to maintaining competitive neutrality.<sup>49</sup>

#### *Privatisation of Public Utilities: The OECD Experience*

The Corporate Governance report on **Privatisation of Public Utilities: the OECD Experience** (OECD, 1999) also raises the issue of moral hazard as a deterrent to market entry by private sector competition. If the market perceives SOE debt as government debt, and there is a history of SOE bailouts, this may be enough of a deterrent for private competitors to enter the market. This problem is further accentuated in certain sectors, such as public utilities, where building public utilities infrastructure, is capital intensive and is a market where there are typically high entry barriers. Limited access to capital, in comparison with SOE counterparts, would be a significant deterrent to market entry.

#### *Conclusions on debt neutrality*

The need to avoid concessionary financing of SOEs is commonly accepted since most policy makers recognise the importance of subjecting state-owned businesses to financial market disciplines.

Competition and other regulatory authorities in EU and many other jurisdictions enforce competition law to rein in outright subsidies and state aids, and subject SOEs to market conditions in accessing finance. Despite such advances, debt neutrality remains an important area to tackle if the playing field is to be levelled. Many government businesses continue to benefit from preferential access to credit in the market due to their perceived government-backing. Existing OECD guidance and recommendations bearing on this topic take into account, among other things, the following:

- OECD Guidance recommends that public enterprises access credit on the same terms as the private sector (SOE Guidelines; Regulating Market Activities by the Public Sector, Roundtable on Competition; State Aids and Subsidies; Competition and Financial Markets). This guidance is generally applicable to state-owned entities and state-owned banks as receivers of credit, but also to state-owned banks also as providers of credit.
- OECD good practices recommend putting into place mechanisms to account for debt neutrality adjustments, drawing upon a number of Member experiences, such as those of Australia and the EU (Regulating Market Activities by the Public Sector, Roundtable on Competition, State Aids and Subsidies).

## **2.8. Public procurement**

### ***Introduction to public procurement***

Outsourcing and other forms of service delivery from outside the public sector are increasingly used to improve efficiency. These include purchase at arm's length, private participation in areas previously controlled by government and the tendering of incipient monopolies to private providers (i.e. concessions and other forms of PPPs). The degree to which the allocation of contracts relies on market mechanisms differs between countries. This is preoccupying, not only because it impedes competitive neutrality and stifles innovation in service delivery; it also makes it harder to achieve value for money in the management of public funds.

A lot of effort at the international level has focused on promoting competitive tendering and improving the process of selection of suppliers for government contracts. Whereas public sector monopolies have become rarer, the boundaries between private and public agents in many economies have become more blurred. In consequence, outright competition or competing activities between private and public enterprises occurs in a number of new areas, effectively multiplying the scope for commercial disputes.

While public procurement procedures are subject to rigorously enforced laws and regulations in virtually all OECD countries, SOEs are predominantly found in sectors where complex contracts and multiple bidding criteria are common. Governments have been accused of benefiting from the complexities and grey zones to effectively giving preferential treatment to their national champions.<sup>50</sup> Notwithstanding the relatively stringent public procurement rules, some SOEs in practice continue to benefit from preference in public procurement. Particularly important for public procurement and competitive neutrality is also the issue of in-house procurement – i.e. the terms and conditions on which a public authority may purchase products or services directly from the organisation it owns and in some cases, services it procures from itself.

In addition to the competitive neutrality barriers detailed elsewhere, public procurement practices may raise additional concerns:

- lack of transparency or discriminatory practices in criteria, procedures or selection process in managed competitions;
- the impact that government policies have on procurement and the procedures used to implement procurement can have an impact on competition in the markets they affect;
- incumbency advantages enjoyed by existing firms. One of the largest sources of competitive non-neutrality relates to the advantages enjoyed by incumbent suppliers during; and,
- general information asymmetries arising from preferential access to information or data which may not be available (or only available to a limited extent) to outside competitors.

Any of these barriers may not necessarily reflect onerous practices at the level of general government – merely an accumulated competitive or informational advantage allowing SOEs to tailor their offers more closely to government requirements. There are also cases where the general government may also face disadvantages competing alongside the private or third sectors.

Some OECD countries are clarifying government policies on procurement; and changing and enforcing procurement policy in a way that equalises competition between the public and private sectors. Some of these good practices are reflected in OECD instruments, guidelines and best practices which are discussed in greater detail below. That said, thus far the primary focus of most OECD governments has been on the fight against corruption, bid rigging and other unethical behaviour by the sellers in public procurement. Less attention has been given to competitive practices or policies addressing all sources of competitive advantages and disadvantages, and how policies are implemented and enforced. The effectiveness of these policies depends on whether they cover all government organisations providing commercial services in competitive or potentially competitive markets.

### ***OECD Instruments bearing on public procurement***

#### *SOE Guidelines*

The **SOE Guidelines** make multiple references to standards that could be applied to SOEs in their own procurement practices (Box 2.26). The SOE Guidelines promote the use of general procurement rules for SOEs just as they would apply to other companies (Guideline 1.A.); this encourages a level playing field in that procurement rules should apply across the board to public and private companies. Furthermore, the SOE Guidelines call for the removal of legal and non-legal barriers to fair procurement (Guideline 1.A.). This may be relevant in situations where certain unfair or discriminatory practices are part of selection criteria to participate in a public procurement bid or tender. Unfair practices can include implicit or explicit national preferences or other preferences that may be used as a bias for selection (i.e. giving preference to a national champion).

The SOE Guidelines promote developing a code of ethics including guidance on procurement processes (Guideline IV.C), the aim obviously being the prevention of illicit or unethical conduct. The SOE Guidelines also recommend setting up specialised board committees in areas like procurement, where there is potential for conflict of interest (Guideline VI.E). Separating procurement and bidding functions into separate departments is one way of avoiding conflicts of interest in entities where in-house bidding takes place. While not directly addressing the issue of competitive neutrality, ensuring ethical conduct and preventing conflict of interest are indeed prerequisites to ensuring a level playing field among suppliers, regardless of ownership.

### Box 2.26. Excerpts from the SOE Guidelines

**Guideline I.A** There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation.

Annotations:

*"General procurement rules should apply to SOEs as well as to any other companies. Legal as well as non legal barriers to fair procurement should be removed."*

**Guideline IV.C** The board of SOEs should be required to develop, implement and communicate compliance programmes for internal codes of ethics. These codes of ethics should be based on country norms, in conformity with international commitments and apply to the company and its subsidiaries.

Annotations:

*"The code of ethics should include guidance on procurement processes, as well as develop specific mechanisms protecting and encouraging stakeholders, and particularly employees, to report on illegal or unethical conduct by corporate officers."*

**Guideline VI.E** When necessary, SOE boards should set up specialised committees to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration.

Annotations:

*"The setting up of specialised board committees could be instrumental in reinforcing the competency of SOE boards...They may be also effective in changing the board culture and reinforcing its independence and legitimacy in areas where there is a potential for conflicts of interests, such as with regards to procurement..."*

### *OECD Recommendation on Integrity in Public Procurement*

To promote good governance and integrity at all stages of the procurement cycle, from the needs assessment through contract management and payment the OECD Public Governance Committee has developed the **OECD Recommendations for Enhancing Integrity in Public Procurement** (OECD, 2009) enacted by Council in October 2008. The recommendations are complemented by Principles and a "tool box" that assists policy-makers with implementation.

The Recommendation (Box 2.27) is primarily directed at policy makers in governments at the national level but also offers general guidance for sub-national government and SOEs. While the SOE Guidelines concern the role of SOEs as public purchasers, the Principles deal with level handed public procurement practices even *vis-à-vis* publicly owned providers of goods and services. In particular, they emphasise ensuring transparency and integrity in the procurement process and promote the use of competitive tendering insisting on "fair and equitable treatment" among potential suppliers with the aim of ensuring "a level playing field" (Principles 1 and 2).

The Principles defines integrity as the use of funds, resources, assets, and authority, according to the intended official purposes and in line with public interest. Integrity violations include a number of practices that are also inconsistent with competitive neutrality:

- corruption including bribery, "kickbacks", nepotism, cronyism and clientelism;

- fraud and theft of resources, for example through product substitution in the delivery which results in lower quality materials;
- conflict of interest in the public service and in post-public employment;
- collusion;
- abuse and manipulation of information;
- discriminatory treatment in the public procurement process; and
- the waste and abuse of organisational resources.

The annotations to Principle 1 further elaborate what is meant by “level playing field”, alluding to neutrality issues that may arise in public procurement. It refers to situations when national preferences or other discriminatory preferences are made and calls for increased transparency on the existence of such preferences (e.g. by publishing criteria for participation in advance) in order to enable “potential foreign suppliers to determine whether they have an interest in entering a specific procurement process”. No further clarification is provided on what is meant by “national” or “discriminatory” preferences and in which situations the scope for restricting competition is permissible, regardless of company ownership or nationality. With regards to competitive neutrality, this leaves room for interpretation and ambiguity, especially in a context where governments are often accused of giving preferential treatment to national champions.

#### **Box 2.27. Principles for Enhancing Integrity in Public Procurement**

**Principle 1: Provide an adequate degree of transparency in the entire procurement cycle in order to promote fair and equitable treatment for potential suppliers.**

Annotations:

Governments should provide potential suppliers and contractors with clear and consistent information so that the public procurement process is well understood and applied as equitably as possible. Governments should promote transparency for potential suppliers and other relevant stakeholders, such as oversight institutions, not only regarding the formation of contracts but in the entire public procurement cycle. Governments should adapt the degree of transparency according to the recipient of information and the stage of the cycle. In particular, governments should protect confidential information to ensure a level playing field for potential suppliers and avoid collusion. They should also ensure that public procurement rules require a degree of transparency that enhances corruption control while not creating red tape to ensure the effectiveness of the system.

**Principle 2: Maximise transparency in competitive tendering and take precautionary measures to enhance integrity, in particular for exceptions to competitive tendering.**

Annotations:

To ensure sound competitive processes, governments should provide clear rules, and possibly guidance, on the choice of the procurement method and on exceptions to competitive tendering. Although the procurement method could be adapted to the type of procurement concerned, governments should, in all cases, maximise transparency in competitive tendering. Governments should consider setting up procedures to mitigate possible risks to integrity through enhanced transparency, guidance and control, in particular for exceptions to competitive tendering such as extreme urgency or national security.

## *Principles for Managing Ethics in the Public Service*

In a context of increased interaction between public and private actors, the Principles for Managing Ethics in the Public Sector (OECD, 1998) are consistent in promoting responsible conduct in public procurement, as they call for a) transparency and disclosure of resources and power entrusted to public institutions (Box 2.28 – Principle 6); and b) clear guidelines on interaction between the public and private sectors (Principle 7).

They echo recommendations of the SOE Guidelines (Chapter IV.C) in ensuring that state ownership is exercised in a professional and accountable manner, with an internal code of ethics holding management and employees accountable according to high ethical standards, with clear ethics guidance on procurement processes.

### **Box 2.28. Excerpts from the Principles for Managing Ethics in the Public Service**

#### **Principle 6: The decision-making process should be transparent and open to scrutiny**

*“The public has a right to know how public institutions apply the power and resources entrusted to them. Public scrutiny should be facilitated by transparent and democratic processes, oversight by the legislature and access to public information. Transparency should be further enhanced by measures such as disclosure systems and recognition of the role of an active and independent media.”*

#### **Principle 7: There should be clear guidelines for interaction between the public and private sectors.**

*“Clear rules defining ethical standards should guide the behaviour of public servants in dealing with the private sector, for example regarding public procurement, outsourcing or public employment conditions. Increasing interaction between the public and private sectors demands that more attention should be placed on public service values and requiring external partners to respect those same values.”*

## *Effective Action against Hard Core Cartel Recommendation*

The OECD recommendation on **Effective Action against Hard Core Cartels** (OECD, 1998) addresses anticompetitive behaviour, particularly highlighting procurement as one of the enforcement priorities that Member countries should pursue in their fight against hard core cartels. The Recommendation defines a hard core cartel as “[...] an anticompetitive agreement, anticompetitive concerted practice, or anticompetitive arrangement by competitors to fix prices, make rigged bids (collusive tenders), establish output restrictions or quotas, or share or divide markets by allocating customers, suppliers, territories, or lines of commerce”.

The scope of this Recommendation is wide. It covers behaviour by “competitors” regardless of legal status or private or public ownership. It is therefore applicable to circumstances in which a bid rigging cartel involves government businesses or government favoured businesses such as national champions.

## *Other good practices and related guidance*

### *Best Practice Guidelines for Contracting Out Government Services*

The **Best Practice Guidelines for Contracting Out Government Services** (OECD, 1997), the Best Practice Guidelines do not differentiate between services offered on a commercial or non-commercial basis, but deal more broadly with the use of market mechanisms to improve service

quality and lead to efficiency gains in service provision. They promote fostering competition and recognise that even where no actual competition may exist “contracting out practices can play a major role in the development of markets for the relevant services”; thus recognising the potential for competition.

The first Guideline serves as a recommendation on how to promote success in opening public services to private participation. It underlines the importance of involving top management in decisions of contracting out, especially if there is resistance by some in the organisation. Drawing on an example from the Indianapolis in the United States, success in contracting out operations of its international airport were attributed to the high-level commitment of the Mayor who took “personal leadership” of the decision to apply principles of competition. While the Guidelines seem to encourage policy makers to be proactive in opening markets to competition, they do not address the political pressures that can be faced by policy makers who may also feel they need to protect SOE public employment because of resistance from interest groups or the general public. For instance, where questions of public employment arise, any failure of the State to maintain civil service jobs could expose politicians to strong public pressures.

The sixth Guideline (Box 2.29) addresses the issue of in-house bidding which deals directly with incumbency advantages and non-incorporated entities. The Guideline stipulates that in-house bids should be treated the same as outside bids. Also discussed in Section 2.2, ensuring special care should be taken to ensure that “all items of cost faced by private sector contractors” are accounted for when evaluating in-house and external contract proposals. The Guidelines further stipulate that costing should be reviewed by “an independent organisation to verify its accuracy”.

**Box 2.29. Guideline 6 on Evaluating In-House Bids**

- An in-house bid occurs when the staff presently performing an activity bids against an outside contractor for an activity being considered for contracting out.
- In-house staff is often in the best position to identify opportunities for work process improvements. Their bid should be judged on the basis of these improvements.
- In-house bids should in all respects be treated the same as outside bids. Special care needs to be taken to ensure that the costing of the bid is complete, i.e. that it incorporates all items of cost faced by private sector contractors. The costing should be reviewed by an independent organisation to verify its accuracy. In-house bidders should also fulfil any accreditation and certification requirements imposed on an outside bidder.
- A winning in-house bid should be awarded to the staff on the basis of a formal document that obligates the staff to meet the terms of their bid. The performance of in-house staff should be monitored using the same processes and criteria used for outside contractors.
- The criteria used for deciding whether to permit an in-house bid should be clear and specific.

The issue of treatment of staff is important, especially if the government imposes requirements on private bidders such as transferring staff from the public sector, matching public-sector wages, or committing to a no-layoff clause.<sup>51</sup> The staffing issue is brought up in two case studies identified as good practice by the Guidelines: in the United Kingdom, where IT functions of the Inland Revenue Department were outsourced; and in the Netherlands, where printing services of the Dutch Tax and Customs Administration were contracted out. In both cases, the Guidelines highlight the benefits of consultation with concerned staff. In the case of the Netherlands, printing services were contracted out

only after an agreement was reached on re-staffing arrangements which were decided together with the employee associations and other stakeholders. Being transparent about costs and liabilities might reveal to potential competition whether it is worth entering a market, especially in cases where there previously was limited or no competition where start-up or transition costs can be prohibitive – particularly where contracts are of a limited duration.

**Box 2.30. Market Mechanisms in Public Service Provision: Example from the Transportation Sector**

Around half of OECD countries require sub-central governments to open sub-central public transport services to competition, generally in the form of tendering. The European Union exerts some pressure through their internal market programme but sector-specific legislation has not yet passed. Jurisdictional fragmentation is an obstacle to achieving satisfactory results, in many countries jurisdictions are too small to allow providers to reach sufficient economies of scale and specialisation, and varying contracting rules make it difficult to optimise cross-jurisdictional services. Many countries are still in a transition period where some jurisdictions have opened their markets while others have not or for parts of their networks only. Moreover, sub-national governments where transport services are produced “in-house”, i.e. through a government agency instead of an autonomous (public or private) company, are not required to tender. Tendering rules are often skewed towards public providers (e.g. private firms have to pay taxes while public agencies do not) or preference may be given to a local incumbent, and only a few countries require strict policy neutrality between private and public providers. For example in Italy local and regional bus services run below optimal density, and most Swiss utilities such as railways are undersized.

Harmonising tendering rules can help overcome inefficiencies and intergovernmental cooperation can improve contracting.

Adapted from: OECD (2008), *Market Mechanisms in Public Service Provision*, Box 2, pp 14-15).

The Guidelines do not address many of the information advantages that an in-house bidder may have in a competitive process. A competitive neutrality framework should also ensure that any information asymmetries be addressed to ensure a level playing field in the bidding process. Any mistrust, uncertainty or misunderstanding surrounding managed competition, or the perception of unfair treatment of private sector versus in-house bids can be a potential deterrent to private sector participation, or can even lead to disputes or lawsuits from private bidders (Box 2.30 for example from transportation sector).<sup>52</sup>

*Guidelines for Fighting Bid Rigging*

A significant portion of domestic cartels concerns bid rigging in auction or procurement procedures. Further to the 1998 Recommendation on Hard Core Cartels, the Competition Committee developed a specific methodology to help governments improve public procurement by fighting bid rigging. The **OECD Guidelines for Fighting Bid Rigging in Public Procurement** (OECD, 2009) assist procurement officials to reduce the risks of bid rigging through careful design of the procurement process and to detect bid rigging conspiracies during the procurement process (for each a checklist has been identified). The purpose of the Guidelines is to help procurement officials to identify:

- markets in which bid rigging is more likely to occur so that special precautions can be taken;
- methods that maximise the number of bids;
- best practices for tender specifications, requirements and award criteria;

- procedures that inhibit communication among bidders;
- suspicious pricing patterns, statements, documents and behaviour by firms, that procurement agents can use to detect bid rigging.

The Guidelines may be applied to competitive neutrality, as any bid rigging practices concerning public procurement can impact how level a playing field is. Many reported cases of bid rigging cases involve state-owned enterprises as organisers of tenders and not as suppliers themselves. Its application in this context is limited to cases where one of the bidders, itself, is an SOE or if the public procurer distorts the procurement process to favour an incumbent SOE, or national champions or other favoured companies. Either way, the procuring authority has a responsibility to stop anticompetitive practices and such responsibility should be included in codes of conduct or ethics including guidelines in order to assure integrity in the public procurement process (this is also reflected Guideline IV.C of the Guidelines for Corporate Governance of SOEs). (See Box 2.31 for an example from the waste collection sector.)

#### **Box 2.31. Example from Waste Collection**

Competitive tendering in strong markets results in lower costs than in-house production, but the effectiveness of competitive tendering depend on the level of competition in the bidding process, competitive neutrality between bidders. Maintaining a level playing field between potential bidders and any local government owned bidders must be carefully maintained. Furthermore, there is a need for contractual terms and conditions and a selection of service providers to be clear and for bid rigging to be actively punished. It should be explicitly acknowledged that there is also risk of corruption amongst local officials, for example in the case of waste collection in France, bids are opened by an independent commission to enhance transparency and eliminate the risk of collusion between bidders and local officials.

*Source:* Adapted from OECD (2000), *Waste Collection*.

#### *From Lessons to Principles for the use of Public-Private Partnerships*

Public-private partnership (PPP), as mentioned, is one form of procurement that is increasingly used by policy makers to deliver public services both with regards to infrastructure and more complex assets such as prisons and health. The use of this form will depend on the incentives that exist for policymakers and the type of governance arrangement that is preferred. The draft hand-out *From Lessons to Principles for the use of Public-Private Partnerships* was submitted in June 2011 to the Working Party of Senior Budget Officials of the Public Management Committee. Designed as a guide for policymakers using PPPs, they cover institutional and procedural features in the governance system that will further a focus on value for money, efficiency, effectiveness and transparency. They are to be presented to Council in the first half of 2012. Assuming that the draft Principles are presented in their current form, they could have implications in a competitive neutrality context.

PPPs in this context are defined as a long-term agreement between the government and a private partner where the service delivery objectives of the government are aligned with the profit objectives of the private partner. While a number of the aspects covered by the draft Principles are linked to the issue of competitive neutrality, they focus mainly on how the public sector maximises value from using (or not using) PPPs and how PPPs treat risks and contingent liabilities transparently (Box 2.32).<sup>53</sup> Their effectiveness depends on a sufficient and appropriate transfer of risk to the private partners. Their success depends on how transparent the public sector is in disclosing costs and liabilities (Principle 5), assessing the degree of competition in and for the market, and determining how much risk can *actually* be transferred when the state has statutory responsibilities to maintain

public services (Principles 6 and 10). Furthermore, once a contract is awarded the market should remain contestable so as not to affect price or quality of service or promise exclusivity in service delivery.

**Box 2.32. Draft Principles From Lessons to Principles for the use of Public-Private Partnerships**

**Principle 5. The project should be affordable and transparently treated in the budget process – regardless of which level of government it applies to.**

*“Budget documentation must disclose all information regarding present and future costs and liabilities of PPPs in a transparent way. The information should include what and when the government will pay, and full details of guarantees and contingent liabilities.”*

**Principle 6. Carefully investigate which investment method yields most value for money.**

*“What is the potential level of competition for the market and what is the potential level of competition in the market?”*

**Principle 10. Ensure competition and integrity in the procurement process**

*“Competition helps ensure the effective transfer of risk...in its absence the government effectively carries the risk.”*

*“In markets where competition is absent after the award of the contract, the market should at least remain contestable – thus, the private partner should know that there is always the possibility of alternative private partners entering the market.”*

***Conclusions on public procurement***

The basic criterions for public procurement policies and procedures to support competitive neutrality are that procurement practices should be competitive and non-discriminatory; ensure high standards of transparency; and all public entities participating in a bidding process should be considered equally. However, some additional issues may arise. Where long-existing SOEs or in-house providers are involved, their incumbency advantages may be such that the entry of competitors is effectively impeded. To a certain extent these advantages may be classified as traditional economies of scale that do not in principle relate uniquely to competitive neutrality. However, if the authorities are intent on obtaining a truly competitive environment then they nevertheless have to be considered. The following points emerge from OECD guidance that bears on public procurement and competitive neutrality:

- The SOE Guidelines recommend that general procurement rules should apply to SOEs as they would apply to other companies.
- A number of OECD guidance have recommended transparency in procurement policies and procedures; in setting clear selection criteria in advance; and ensuring fair and equitable treatment in the selection of suppliers. Any unfair barriers are recommended to be removed to ensure fair and un-discriminatory selection processes. Where discriminatory preferences exist, OECD recommends that these should be made transparent in the selection criteria shared with potential bidders in advance (SOE Guidelines, OECD Principles for Enhancing Integrity in Public Procurement, Guidelines for Contracting out Government Services,

Principles for Managing Ethics in the Public Sector). This guidance applies to SOEs as purchasers.

- The Best Practice Guidelines for Contracting out Government Services recommends that in-house bids should be treated the same as outside bids in terms, and neutrality should be safeguarded between private and public providers.
- OECD guidance stresses integrity and ethics as essential in the procurement process. (SOE Guidelines, OECD Principles for Enhancing Integrity in Public Procurement, Principles for Managing Ethics in the Public Sector, Effective Action Against Hard Core Cartels, Guidelines for Fighting Bid Rigging in Public Procurement.) This applies to SOEs as public purchasers and organisers of tenders. The Recommendation on Cartels also applies to state undertakings participating as suppliers themselves.

## Notes

1. The annotated text provides further explanation on how to deal with certain obligations if indeed the SOE's legal form is streamlined. In particular, pensions of public employees are mentioned as an important consideration to be made as it represents a significant liability, but also an obligation and possibly a disadvantage for the SOE. Such issues are discussed further in Sections 2.2 and 2.6.
2. OECD, *Restructuring Public Utilities for Competition* (2001), at p. 53.
3. Ibid.
4. Nestor and Ladan Mahboobi (1999), p. 8.
5. OECD (2009), *System of National Accounts* (2009), OECD, Paris, Chapter 4, p. 80.
6. Some of these points also apply to recommendations in Section 2.3 for what concerns commercial rate-of-return and Section 2.4 for what concerns accounting for public service obligations.
7. Part of the justification in accepting lower rates of return by SOEs is to allow it to price at below costs in order to meet specific public service obligations. According to the Guidelines, whenever possible, prices should be based on competitive market prices and should be based on the principle of full cost recovery. If prices reflect anything other than market prices, the economic rationale should be made transparent. The Best Practices also caution against cross-subsidisation. To this end, the guidelines recommend transparency surrounding the degree of subsidy, especially if the prices charged are below cost recovery. The guidelines suggest setting and monitoring "specific financial, service quality and other performance targets". This is particularly important as the degree of subsidy should be adequate if calculated according to agreed upon objectives, accurate costing and specific performance targets. These points also apply to Sections 2.3 and 2.4.
8. OECD (2005), *Journal of Competition Law and Policy*, Vol. 7, No. 3, OECD, Paris, p. 50.
9. OECD (2011), "Competitive neutrality and State-Owned Enterprises: Challenges and policy options", *OECD Corporate Governance Working Papers, No. 1*, [www.oecd.org/daf/corporateaffairs/wp](http://www.oecd.org/daf/corporateaffairs/wp), p. 19. Non-profit seeking behaviour of SOEs compared with private sector companies in Sappington and Sidak (2003), *Competition Law for State-Owned Enterprises*, 71 *Antitrust Law Journal*.

10. OECD (2009), *Competitive Neutrality*, p. 36.
11. When benchmarking performance, it is also necessary to identify the significant differences with the SOE concerned, in terms of status, regulatory environment, market presence, etc., and the extent to which these dimensions might have an impact on objectives and performance. While not directly aimed at calculating rates of return, these methods can be useful to gauge performance when industry-specific comparisons cannot be made.
12. The report also addresses concerns over predatory pricing as it relates to international trade practices; these issues are not covered in the scope of this paper.
13. OECD (2009), *State Owned Enterprises and the Principle of Competitive Neutrality*, p. 36. A successful antitrust predation case normally hinges on whether a company lowering prices has a realistic chance of “recoupment” (the clawing-back of lost revenues through subsequent price increases).
14. OECD (2004), *Predatory Foreclosure*, OECD, Paris. For more on this topic also see: OECD (2005), “Policy Brief on Preserving Competition: Keeping Predators at Bay”, OECD, Paris.
15. For example, D.E.M. Sappington and J.G. Sidak (2003), “Competition Law for State-Owned Enterprises”, *Antitrust Law Journal*, Vol. 71, No. 2.
16. See Section 2.8 for more on public procurement. OECD (2004), *Regulating Market Activities by the Public Sector*, (p. 32) provides further clarification as to what differentiates commercial activities from non-commercial activities. Further reading on this topic can also be found in the 2010 *Report on Universal Service Obligations*. Some OECD governments reserve certain sectors (e.g. higher education, hospitals, and prisons) for the public sector; this paper does not pass judgement on this choice as it is considered within their sovereign right to regulate – even if in some other countries private companies are active in these areas. However, a discriminatory granting of access to selected markets or SOEs enjoying privileged market activities are not compatible with competitive neutrality and do fall within the scope of issues discussed in this paper.
17. According to the *INTOSAI Lima Declaration of Guidelines on Auditing Precepts*.
18. Such as the International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP).
19. OECD (2010), *Accountability and Transparency: a Guide for State Ownership*.
20. As noted in OECD (2004), *Regulating Market Activities by the Public Sector*, it can be difficult to calculate the avoidable costs of government business activities and then benchmark these according to similar private entities. Often government businesses lack transparency or their accounting practices are poor.
21. Schick, A. (2007), “Off-Budget Expenditure: An Economic And Political Framework”, *OECD Journal on Budgeting*, Volume 7, No. 3 (2007).
22. The *From Lessons to Principles for the Use of Public-Private Partnerships* (OECD, 2011), currently under review by relevant OECD Committees, points out that PPPs are increasingly used to circumvent budget expenditure limits. According to the draft principles, the use of PPPs should not compromise competition in the market and should not give exclusivity to one provider of such services.
23. OECD (2008), “Market Mechanisms in Public Service Provision”, *Economics Department Working Paper*, OECD, Paris.

24. OECD (2000), “Competition in Local Services: Solid Waste Management”, provides a detailed account of these issues in the waste collection sector, specifically it says, “Local governments with a soft budget constraint face weak incentives for ensuring cost minimisation in the services they provide. There may be a link between soft budget constraint and the size of transfer from the central government. Local governments can often act strategically to enhance the likelihood of additional transfers from the central government by cutting or threatening to cut those services...many governments impose various forms of constraints. Examples include the requirement on many local governments in the US to maintain a balanced budget or the requirement in the United Kingdom to conduct competitive tendering...”.
25. Neutrality issues arise in the telecommunications sector due to the presence of “network effects” – i.e. when the demand for a firm’s services increases with the consumption of its services. Due to the nature of the sector, network externalities tend to provide incumbents with a competitive advantage in a given market. However, such competitive advantages may exist only in markets where there is a high concentration of consumers, as such government intervention is rationalised to incentivise telecommunications providers (both infrastructure and services) to expand coverage to areas which may be less profitable but which should be provided a minimum level of service (as determined according to national or regional policy). Often, such incentives involve implicit cross-subsidies.
26. Regulatory restraints on competition often exist in postal services, most commonly to permit the incumbent firm a source of revenue to fund mandated public service obligations. The postal sector is a good example of an industry sector where anti-competitive practices by SOEs are common. This is due to a number of reasons. First, in many countries, the level of government involvement in the postal sector is significant. Most postal services are (or used to be) government-owned entities. Second, the SOEs are very large companies with significant market presence. Third, many public postal operators still enjoy monopoly rights over a number of postal services (such as letter delivery) and at the same time compete with private firms in a number of other markets (such as parcel or express mail delivery). In the postal sector, moreover, complaints of cross-subsidisation and predatory pricing are common.
27. OECD (2009), *State Owned Enterprises and the Principle of Competitive Neutrality*, also see Floyd, R.H. “Income Taxation of Public Enterprises”, IMF Staff paper, p. 323.
28. The impact of exempt status on competition has been the subject of recent literature. See: European Commission (2010), Green Paper on the Future of VAT, “Towards a simpler, more robust and efficient VAT system”, p. 10. Also See Gendron, P. (2005), “Value-Added Tax Treatment of Public Sector Bodies and Non-Profit Organizations: A Developing Country Perspective”, ITP Paper 0514, July 2005, p. 8 and references cited under FN 5 of Gendron’s paper.
29. In EU countries this applies within certain limits as described in Article 13 of the VAT Directive (e.g. where treatment of public bodies as non-taxable persons would lead to significant distortions of competition).
30. The SOE Guidelines require that “any financial assistance, including guarantees, received from the state” (Guideline V.E.4) be disclosed and accounted for. Although taxation is not explicitly mentioned, the annotated text refers to “any state grant or subsidy received”. Tax exemptions can be considered an indirect subsidy and should be accounted for in the same way as direct subsidy. The guidelines do not provide any further guidance on how to calculate such differences in treatment, but the general principles of transparency and disclosure are relevant and applicable.
31. Note that the Guidelines are silent on neutral treatment within a particular country. For example, some businesses may be exempt from VAT while others are taxable so distortions often exist within a particular country.
32. OECD (2011), *OECD International VAT/GST Guidelines – Guidelines on Neutrality*, p. 13.

33. At the time of the review, Finnish state enterprises were subject to income tax exemptions on any net income from business operations if their operations were mainly (more than 50%) directed at serving other state agencies. Due to this exemption, state enterprises' average income tax rate was around 11%, compared to the 29% corporate income tax rate. According to the Finnish review (p. 37), "It is feasible to neutralise the advantage by setting performance targets on a before tax basis but this is an extra layer of complication and is not ensured to work well. An argument that the exception is justified because it is the State that is paying for the services, so that removing the exception would simply increase costs to the State, rests on an accounting fiction".
34. According to the review, "The rationale for legislating a monopoly reserved area, or imposing special taxes on limited entry, is to realise a public interest objective, i.e. to fund the universal service obligation by means of cross subsidisation within the reserved areas from profitable services (e.g. mail within cities) to non-profitable services (e.g. rural area mail)". [OECD (2003), Finland, p. 48].
35. OECD (2003), Finland FN 61. In other cases VAT may be generally preferred to a turnover tax.
36. Taxation may happen in a limited number of cases (e.g. where production is used for the private benefit of employees).
37. OECD (2003), Norway, p. 27. At the time this report was published (2003), the authors describe the status of the proposed remedy as follows, "The VAT treatment of municipal services has been studied by a preparatory committee, which handed over its report to the Ministry of Finance on 10 December 2002. The committee proposes VAT compensation for all municipal purchases (which implies an extension of the present VAT system with VAT compensation of only specified services). The Government will follow up on the committee recommendations with proposal to the Parliament in the 2004 budget".
38. This is mentioned under Guideline I.A.: "There should be a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation".
39. There has been significant progress in OECD countries in the liberalisation of many of the sectors traditionally dominated by state monopolies. While this process can be coupled with full or partial privatisation of state monopoly incumbents, privatisation or liberalisation alone is not sufficient in eliminating the advantages that such entities enjoy due to their past state ownership and their position in the market. These types of services may not be able to rely on competition to produce efficient outcomes to the presence of economies of scale – when a single firm can meet market demand more efficiently than any combination of two or more firms.
40. For more on this topic see: OECD (2011), *The Regulated Conduct Defence*.
41. These sectors have long been considered markets with high-entry barriers, prone to market failures due to their structure; they are often sectors where remaining SOEs or privatised incumbents have maintained monopoly rights in part of their value chains; and which receive compensation for public service obligations. This may be due to vertical integration, natural monopoly cost conditions, network externalities, current or previous state ownership, public service obligations or information asymmetries.
42. Also see : <http://www.oecd.org/dataoecd/28/44/32689476.pdf>
43. See also Regulating Market Activities by the Public Sector [http://www2.oecd.org/oe.cd/info/info.aspx?app=OLIScoteEN&Ref=DAF/COMP\(2004\)36](http://www2.oecd.org/oe.cd/info/info.aspx?app=OLIScoteEN&Ref=DAF/COMP(2004)36)(2004). For a comprehensive role of the role of regulator in the transport industry, see OECD/ITF, *Better Economic Regulation: The Role of the Regulator*, (2011), Paris.

44. OECD (2010), “Competition, State Aids and Subsidies”, p. 225.
45. Borisova, G. and Megginson, W.L, “Does Government Ownership Affect the Cost of Debt? Evidence from Privatization”, September 2010, points out that the Faccio, Masulis, and McConnell (2006) study of firms in 35 countries concluded that politically-connected firms are more likely to be the beneficiaries of a government bail-out than non-connected firms. It also points out that the Brown and Dinç (2009) study covering a sample of banks in emerging markets, found that no bank with over 50% government ownership fails in their seven-year period, whereas about 44% of the remaining banks fail, are acquired, or are nationalised by the state.  
[http://www.fbcorporatefinance.fr/medias/cahiers\\_de\\_recherche/wp13\\_megginson\\_privatization.pdf](http://www.fbcorporatefinance.fr/medias/cahiers_de_recherche/wp13_megginson_privatization.pdf)
46. OECD (2009), *State Owned Enterprises and the Principle of Competitive Neutrality*, p. 36.
47. OECD (2004), p. 197.
48. Ibid, p. 274.
49. See, <http://www.oecd.org/dataoecd/45/16/43046091.pdf>, [pp.145 and 214 (FN46)].
50. This is by no means limited to SOEs. This allegation is for example one of the recurrent themes in public debate concerning the competition between Boeing and EADS – only one of which is, partly, state-owned.
51. This was discussed in detail by: Eggers, W. (1998), *Competitive Neutrality: Ensuring a Level Playing Field in Managed Competitions*.
52. Eggers, *Managed Competition*.
53. An existing OECD instrument focuses on value maximisation aspects of PPPs in infrastructure. Refer to the *Principles for Private Sector Participation in Infrastructure* (OECD, 2007).

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## ANNEX

### OVERVIEW OF RELEVANT OECD INSTRUMENTS, BEST PRACTICES AND REFERENCES BEARING ON COMPETITIVE NEUTRALITY

	Streamlining operational form	Identifying costs	Commercial ROR	Accounting for Public Service Obligations	Tax neutrality	Regulatory neutrality	Debt neutrality	Public Procurement
OECD Instruments								
Guidelines on Corporate Governance of State-Owned Enterprises (by implication the Principles of Corporate Governance)	X	X	X	X	(X)	X	X	X
Council Recommendation concerning Structural Separation in Regulated Industries	X							
Report on Regulatory Reform and its Recommendations	X					X		
Recommendation of the Council on Improving the Quality of Government Regulation						X		
Guiding Principles on Regulatory Quality and Performance						X		
Principles for Managing Ethics in the Public Service				X				X
Recommendation of the Council on Competition Assessment						X		
Recommendation on Competition Policy and Exempted or Regulated Sectors	X					X		
Policy Framework for Effective and Efficient Financial Regulation						X		
Recommendation for Enhancing Integrity in Public Procurement								X
Recommendation Concerning Effective Action against Hard Core Cartel								(X)
OECD Council Recommendation on Broadband Development				(X)		(X)		
OECD Council Recommendation on Regulatory Policy and Governance						X		

Good Practice Documents								
OECD Competition Assessment Toolkit						X		
Best Practices for Budget Transparency		X		X				
Best Practice Guidelines for User Charging for Government Services		X	(X)	(X)				
Best Practice Guidelines for Contracting Out Government Services		X						X
Best Practice Guidelines – Off budget and Tax Expenditures				X				
International VAT/GST Guidelines: International Guidelines on Neutrality					X			
APEC-OECD Integrated Checklist on Regulatory Reform						X		
Guidelines for Fighting Bid Rigging in Public Procurement								(X)
Other relevant OECD references								
Regulating Market Activity by the Public Sector		X	X				X	
Privatisation in the 21 <sup>st</sup> Century: Recent experiences of OECD Countries/Privatisation of Public Utilities	X						X	
Accountability and Transparency: A Guide for State Ownership		X	X	X				
Competition Report on Predatory Pricing			X					
From Lessons to Principles for the Use of Public-Private Partnerships				(X)				(X)
Report on Universal Service Obligations				X				
Market mechanisms in public service provision				X				
Promoting Performance: Using Indicators to Enhance the Effectiveness of Sub-central Spending				X				
Marketisation of Government Services – State-Owned Enterprises					X			
Competition and the Financial Markets (Volume 2)							X	
Key: X = Directly bears on competitive neutrality; (X) = Peripherally bears on competitive neutrality								

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