2 State intervention and competitive neutrality

This chapter provides an overview of the main ways in which the state intervenes in markets, including when it (i) establishes and enforces the regulatory environment, including competition law; (ii) acts as a buyer or supplier of goods and services; (iii) influences the choices of suppliers through state support; and (iv) supports the provision of public services by either privately-owned or publicly-owned enterprises. In addition, it describes the potential to distort competition of each of these state interventions and how they are addressed by the OECD Recommendation on Competitive Neutrality. It also presents the scope of the Recommendation.

When markets work well, they allocate resources efficiently and can maximise welfare (OECD, 2014[1]). Markets, however, may not always work effectively or achieve desired outcomes and therefore state intervention may be helpful. The rationale for state intervention in the economy is often described in terms of two main groups of objectives (Stiglitz, 2009[2]). The first concerns efficiency considerations, that is situations in which markets do not work well on their own, due to so-called market failures. Intervention that addresses market failures attempts to correct issues such as externalities, natural monopolies or information asymmetries.[1] The second consists of wider policy objectives, for instance ensuring that all citizens have access to basic goods and services, such as water, or promoting security of food and energy supply.[2]

This chapter lists the main forms of intervention and flags their potential to distort competition. These different ways in which governments intervene in markets are addressed by the Recommendation, whose scope is also described in the chapter. The last section summarises why competitive neutrality matters.

2.1. State intervention in markets

Government pursues its objectives by intervening in markets in a variety of ways. Intervention can be direct, if the government is a buyer of goods and services or is a market player, or indirect, when it acts as a regulator or tries to influence consumer behaviour (Office of Fair Trading, 2009[3]).

The Recommendation lists the various forms of state intervention in markets and calls for the state not to distort competition while trying to achieve their policy objectives, "to the maximum extent practicable and unless overriding Public Policy Objectives require otherwise". Competitors have a level playing field, or in other words competitive neutrality, "where no entity operating in an economic market is subject to undue competitive advantages or disadvantages" (OECD, 2012[4]).

The Recommendation focuses on preserving competitive neutrality when the state intervenes:

1. **establishing and enforcing the regulatory environment** (addressed in more detail in Chapter 3 on competition law and enforcement; Chapter 4 on regulatory environment);
2. **government's role as a buyer or supplier of goods and services** (Chapter 5 on public procurement);
3. **influencing the choices of suppliers through state support** (Chapter 6 on state support);
4. **supporting the provision of public services by either privately-owned or state-owned enterprises** (Chapter 7 on public service obligations).

Government's behaviour as an owner of enterprises is addressed in detail by the OECD Recommendation on Guidelines on Corporate Governance of State-Owned Enterprises, reviewed in 2024 [OECD/LEGAL/0414] (hereafter the "SOE Guidelines").

2.1.1. Competition law and enforcement

The state ensures the functioning of basic institutions, such as property rights and the enforcement of contracts, that are necessary for markets to work. Establishing and enforcing a competition law framework is part of the state's function of creating the conditions for markets to exist. This is especially important from a competitive neutrality point of view. When large companies can use their market power to distort market outcomes or certain market players, such as SOEs, enjoy implicit benefits, competition law has a role in addressing these situations. In the absence of competitive neutrality, competition is distorted causing markets to operate less efficiently and welfare to be reduced. Thus, the Recommendation singles out neutrality in the competition law and its enforcement when stating the more general principle of competitive neutrality in the regulatory framework.

In some countries, some or all types of government activity, including as a market actor through SOEs, may be specifically exempted from competition law. Such an exclusion is not competitively neutral – for example, if the conduct of SOEs is not subject to competition law but that of their private sector rivals is, SOEs can engage in anti-competitive conduct without the risk of prosecution. In addition, the cost of compliance with competition law is not borne by the SOEs but by the private sector business. The result is distortionary. Moreover, the enforcement of competition law and preserving competitive neutrality may also be more challenging when it comes to SOEs (OECD, 2018[5]).

The enforcement of competition law may interact with other government policies and may therefore need to take the effects of these policies into account. For example, when state support is involved, this may have an impact on a company's ability to recoup losses from predation. When undertaking an analysis of the effects of alleged anti-competitive conduct, the competition authority should therefore consider whether any non-competitively neutral public policy has had an impact on this analysis (OECD, 2022[6]).

Chapter 3 of this document provides guidance on promoting competitive neutrality in the enforcement of competition law.

2.1.2. Regulatory environment

"Regulatory environment" refers to a broad range of actions by the state, from primary legislation establishing framework laws, such as the competition law, to detailed technical regulations introduced and enforced by specialised bodies such as sector regulators. Regulation is crucial to help markets work and to ensure that they deliver outcomes that are in line with government's policy goals.

Policy makers, however, should be aware that regulation may sometimes have unintended consequences on competition. For instance, imposing product standards that are used by certain competitors, but not others, will tilt the playing field in their favour. Competition will also be distorted if some market players, for example incumbents, are subject to old regulations that are less costly to comply with, while new entrants must abide by new and stricter regulations.

The intervention of policy makers should have a clear rationale and minimise "the distortion of competition subject to achieving the [policy] goal" (Office of Fair Trading, 2009[3]). This can be done by carrying out a competition assessment to analyse the potential impact of regulation on competition, as set out in the OECD Recommendation on Competition Assessment [OECD\LEGAL\0455].

Chapter 4 of this document provides guidance on conducting such analysis from a competitive neutrality point of view.

2.1.3. Public procurement

Government participates in markets both as a seller and as a buyer of goods and services. As a buyer of goods and services, government usually accounts for a significant proportion of the economy.[3] It usually procures goods and services through open tenders with competing bidders, to ensure value for money. When government is an important buyer in a given market, it can also affect its competitive dynamics. For example, it can push suppliers to lower prices in the short term and encourage bidders to innovate and develop new solutions in the longer term (Office of Fair Trading, 2009[3]).

Public procurement tenders may contain terms that favour one supplier (or group of suppliers) over others. This could be intended to promote domestic manufacturing and reduce imports, for instance by requiring product standards unique to the country or a surcharge on the price quoted by offshore suppliers. There may be good reason for doing so; for example, disruptions to supply chains during the recent pandemic have highlighted various security issues associated with reliance on imports of essential products. These limitations, especially if used outside emergency situations, have the effect of tilting the level playing field in favour of certain market players.

In countries where there are SOEs supplying goods and services to the state, there is the risk that these market players will have a favourable treatment compared with their privately-owned competitors. Good practice shows that the public procurement framework does not unduly benefit SOEs as sellers, ensuring at the same time that the framework promotes the participation of the largest number of suppliers (CNMC, 2021[7]).

Chapter 5 of this document provides guidance on promoting competitive neutrality in public procurement.

2.1.4. State support

State support includes direct grants, loans, tax exemptions, capital injections, and guarantees, as well other advantages such as allowing enterprises to rent public land or buildings at a price that is lower than the market price.

State support can be used to change the incentives and the behaviour of enterprises, for instance when there are market failures and the market on its own would not achieve an outcome that is desirable for society. Governments may also wish to temporarily support companies that are in financial difficulties, for instance as seen during the Covid-19 pandemic. Support can be granted to both privately-owned companies and SOEs. Given their important role in many economies, SOEs are important recipients of state support and tend to receive relatively more support than privately-owned companies (OECD, 2023[8]) and they can also be providers of subsidised inputs such as energy or capital.

From a competitive neutrality perspective, state support has the potential to distort competition, both in domestic markets and internationally. This occurs when state support benefits some competitors but not others, i.e. it involves a certain degree of selectivity. As a result, the competitors benefitting from support would have less incentives to be efficient and competitive. Similarly, state support may result in inefficient firms, which would have otherwise exited the market, remaining in the market.

The definition of when state support grants a selective advantage varies across jurisdictions, as does the legal and institutional framework to identify and address the potential distortions resulting from state support (OECD, 2010[9]). Among the good practices identified, if the support by policy makers benefits specific competitors, it is expected that it has a clear policy objective. The examples of good practices also show that it should be demonstrated to what extent the support helps achieve that objective and only proceed with a selective support measure when it is not possible to identify a less distortive measure that can meet the same goal.

Chapter 6 of this document provides guidance on preserving competitive neutrality when granting state support.

2.1.5. Public Service Obligations

Public services include services that governments consider important for all citizens and therefore supports their provision and affordability, such as water and sanitation, electricity or rail services. The state can provide them directly, through an SOE, or through private firms. The state may contribute financially to ensure that the public services are available at affordable prices to all citizens, including those living in areas that are costly to serve. This contribution is necessary if the public service provision results in a financial burden for the supplier, who would not have an incentive to provide it if there was no government intervention.

From a competitive neutrality perspective, if the supplier or suppliers of public services compete with other market players, there is a risk that public service provision is either an advantage or a disadvantage, resulting in distortions to competition. If the public service obligation is overcompensated, the additional financial resources can be used to cross-subsidise the services provided in competition with other market players. Vice versa, if the compensation for the public service obligation is not sufficient, the supplier or suppliers will have to use their financial resources to cover the provision of public services. In both cases, the compensation of the public service tilts the playing field.

While the availability and affordability of certain services are important, it is good practice to follow competitive neutrality principles both when awarding the provision of those services and when establishing the compensation for their provision.

Chapter 7 of this document provides guidance on preserving competitive neutrality in the award and compensation of public service obligations.

2.2. What is the scope of the OECD Recommendation on Competitive Neutrality?

The Recommendation defines competitive neutrality as a *"principle according to which all [e]nterprises are provided a level playing field with respect to a state's (including central, regional, federal, provincial, county, or municipal levels of the state) ownership, regulation or activity in the market."* It recommends that government intervention, as described in Section 2.1, does not distort competition in markets, that is, that it does not tilt the playing field in favour of certain market participants.

The definition comprises a number of elements, including the following:[4]

- It covers the state's intervention directly in the market ("activity in the market"), as well as its role as an owner and as a regulator.[5]
- It concerns "enterprises" active in a market and potential competitors. The Recommendation defines an enterprise as "any entity engaged in offering goods or services on a market, irrespective of its legal form".
- It covers the state's ownership, regulation and activities at all the levels of the state, which may depend on how jurisdictions are organised. For instance, in some jurisdictions local authorities may issue regulations and also be active in the economy, through fully or partially-owned enterprises.

The definition of competitive neutrality is useful when there could be more than one enterprise on a market. The implication is that competitive neutrality is not strictly a concern, for example, when goods and services are only provided by the public sector. It may become an issue for international competitors, though, or for markets that are vertically related to the one in question.

The Recommendation refers to enterprises that should be guaranteed a level playing field, regardless of factors such as their ownership, location or nationality. Therefore, it does not concern only competitive neutrality between state-owned enterprises and privately-owned enterprises, but it is much broader. It covers, for example, a differential treatment between privately-owned competitors, such as new entrants and incumbents, and between enterprises located in different regions or different countries.

More specifically about ownership, the Recommendation recognises that different jurisdictions may have different institutional set-ups concerning SOEs. For this reason, it defines SOEs as enterprises that engage in economic activities rather than focusing on their legal form. Consistently with the SOE Guidelines, according to the Recommendation an SOE is recognised by national law as an enterprise and the state exercises ownership or control of that enterprise [OECD/LEGAL/0414].[6]

In practice, establishing if an entity qualifies as an SOE involves ascertaining both its ownership and control structure and the economic nature of its activities, noting that it may conduct economic activities either exclusively or alongside public-policy objectives.

Competitive neutrality is also important in relation to competition between domestic and foreign enterprises and the Recommendation aims at promoting a level playing field between domestic and foreign competitors. State support and favourable regulations can be used to support domestic enterprises competing in international markets. This is especially relevant for SOEs: the public sector is estimated to hold more than 50% of shares in almost 10% of the largest listed companies worldwide (De La Cruz, Medina and Tang, 2019[10]). SOEs are also increasingly active internationally, through trade and investment, as well as playing important roles in supply value chains. Therefore, any state support they benefit from in a selective way can distort competition in international markets too.

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Notes

[1] Externalities refer to situations when certain individual choices create costs or benefits for other consumers or firms. The individual that makes the choice, however, does not internalise these additional costs or benefits and therefore their choices are not optimal for society. While in many markets some suppliers can exercise market power to some extent, in some markets it is more efficient for only one supplier to deliver the good or service. This situation, which usually arises due to significant fixed costs required to enter the market, is called natural monopoly. It calls for government intervention to constrain the natural monopolist's market power. When consumers only have imperfect information about goods or services before buying them, it can be hard for them to distinguish higher quality alternatives from lower quality ones. Due to this problem, higher quality suppliers will find it difficult to sell their goods at higher prices. Government can help by improving the information available to consumers, for instance imposing labelling requirements on producers.

[2] These types of intervention are additional to the basic institutional structure in which firms can operate and compete, such as establishing "the rules of law" and providing national defence.

[3] According to OECD data, OECD countries spend more than 10% of GDP on government procurement. See www.oecd.org/gov/public-procurement, accessed on 9 May 2023.

[4] The definitions used in the OECD Recommendation on Competitive Neutrality are consistent with those in the SOE Guidelines [OECD/LEGAL/0414]. They are explained and illustrated with examples in the introductory chapter of OECD (2012[4]).

[5] The SOE Guidelines [OECD/LEGAL/0414] deal with the state as an owner, for instance concerning the appointment of boards and the arms-length relationship between the owner and the SOEs.

[6] For the avoidance of doubt, competitive neutrality is concerned with SOEs performing economic activities such as commerce and not with public entities charged with economic policy-making.

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