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ABSTRACT

The legal origins literature overlooks a key area of corporate governance—the governance of state-owned enterprises ("SOEs"). There are key theoretical differences between SOEs and publicly-traded corporations. In comparing the differences of both internal and external controls of SOEs, none of the existing legal origins allow for effective corporate governance monitoring. Because of the difficulties of undertaking a cross-country quantitative review of the governance of SOEs, this Article examines, through a series of case studies, SOE governance issues among postal providers. The examination of postal firms supports the larger theoretical claim about the weaknesses of SOE governance across legal origins. In itself, the lack of effective corporate governance would not be fatal if some of the SOE's inefficient and societal-welfare-reducing behavior could be remedied under antitrust law. However, a review of antitrust decisions on the issue of predatory pricing by SOEs reveals that antitrust is equally ineffective in its attempts to monitor SOEs. This Article concludes by identifying a number of devices to reduce the current inadequacies of both antitrust and corporate governance of SOEs.

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I. INTRODUCTION

Beginning ten years ago, an article by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (commonly referred to as "LLSV" even though some subsequent articles have had a slightly different cast of characters) transformed the debate on corporate governance by coding at the country level the amount of investor protection provided under corporate law.[1] They found that

1. I would suggest that the transplant effect/legal origin of many systems is not very clean and changes over time. For example, countries may in certain areas base their company law on the UK, their trusts and estates law on Germany, and their antitrust law based on the EU. What then is the legal origin of the country? In other cases, the law on the books does not reflect law in practice. For example, Argentine antitrust law was modeled on the EU but its analytical approach for many years followed the U.S. antitrust tradition of the Chicago School. Germán Coloma, *The Argentine Competition Law and Its Enforcement, in* LATIN AMERICAN COMPETITION LAW AND POLICY 95–98 (Eleanor M. Fox & D. Daniel Sokol eds., 2009). Moreover, in practice I would see some of the U.S. common law approach incorporated into the fabric of deals involving Latin America, where the origin seemed a hybrid of the host Latin American country and N.Y. law in part because Latin American practitioners had spent time in the offices of N.Y. firms like Cleary Gottlieb, Sullivan & Cromwell, and Shearman & Sterling as well as studied for LLMs in the United States. One practitioner in Chile told me, "I specialize in Chilean-N.Y. law and in the area of corporate law. I think that this is the dominant approach in the country."

LLSV makes certain assumptions about history and political economy in legal origins that are not supported by the underlying historical record. Holger Spamann, *The 'Antidirector Rights Index' Revisited*, REV. FIN. STUD. (forthcoming). A number of scholars have attacked LLSV on these grounds. Nevertheless, LLSV does have an intuitive appeal. In many ways, the results are what you would expect if you were to individually attempt to rank countries based on investor protection or other similar features. More importantly, a number of the variables that LLSV use are a bit squishy, but given the limitations of cross-country quantitative analysis, this may be the best available approach thus far.

the level of investor protection of the underlying rules varied systematically based upon the origin of the legal system. LLSV concluded that common law jurisdictions were more protective of outside investors than civil law jurisdictions.[2] In a series of papers in the subsequent decade, the LLSV team extended this initial research to determine that legal origin had an impact in the area of law and finance.[3] Additional LLSV articles found that legal origins could explain outcomes in areas as diverse as bank ownership,[4] legal formalism,[5] government ownership of media,[6] and regulatory schemes that created barriers to entry.[7]

Though the LLSV literature addresses a number of important issues regarding legal origin, corporate governance, government ownership, and economic growth, LLSV did not ask an important question—under which legal origin is it most effective to limit distortions in the economy caused by state-owned enterprises ("SOEs")? Stated differently, the legal origins literature overlooks a key area of corporate governance—the governance of SOEs, which are a significant part of most countries' economy. The issue of SOEs, their governance and their impact in the world economy has taken on a particularly important role as a result of the worldwide economic crisis. In many countries, nationalization of industries has

From a policy perspective, the key to changing various bottlenecks to economic growth requires not merely a top-down approach in the change of the legal system, but also a bottom-up approach by the users of these legal systems to overcome regulatory distortions. Over time, the common law/civil law distinction will be seen as a rather false dichotomy. Instead, countries may end up being ranked based on their ability to respond to local and changing conditions.

2. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

3. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002); La Porta, Lopez-de-Silanes, Shleifer & Vishny, *Law and Finance*, *supra* note 2; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006); Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

4. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Government Ownership of Banks*, 57 J. FIN. 265 (2002).

5. Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Courts*, 118 Q.J. ECON. 453 (2003).

6. Simeon Djankov, Caralee McLiesh, Tatiana Nenova, & Andrei Shleifer, *Who Owns the Media?*, 46 J.L. & ECON. 341 (2003).

7. Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Regulation of Entry*, 117 Q.J. ECON. 1 (2002).

either occurred or is at the forefront of policy discussions in areas such as the financial sector. However, the potential effects of nationalization, and of increased state control more generally, have not been fully realized in policy circles.

There are important theoretical differences between SOEs and publicly-traded corporations. In a number of substantive areas, it is typically more difficult to effectively monitor SOEs than private firms. This Article claims that in comparing both internal and external controls of SOEs, neither common nor civil law legal origin regimes effectively monitor SOE corporate governance at the same level as private firms.

Key theoretical insights a half century ago from Alchian and Stigler suggest that managerial slack is less likely in competitive industries.[8] Competition, therefore, can be a substitute for good corporate governance. Empirical work suggests that the inverse is also true. In industries that are not competitive, corporate governance seems to have little impact.[9] This is not to suggest that competition and corporate governance are perfect substitutes. Indeed, LLSV make such an observation.[10] Where there is no competition within an industry, good corporate governance is less necessary than in situations where there is robust competition. One might imagine that because of the imperfect substitutability of corporate governance and competition policy, jurisdictions may need only chose one form of regulation to ensure economic gain for society. However, as this Article will illustrate, neither corporate governance nor competition law as practiced for SOEs seem particularly effective as currently constituted.

Good corporate governance may provide firms with an edge over competitor firms. It may also improve resource availability within the firm, and "better" corporate governance may lead to improved performance.[11] There are two strands of research on the topic. One

8. *See* Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950); George J. Stigler, *The Economies of Scale*, 1 J.L. & ECON. 54 (1958).

9. Xavier Giroud & Holger M. Mueller, *Does Corporate Governance Matter in Competitive Industries?*, 3 (European Corporate Governance Inst., Finance Working Paper No. 185, 2007), *available at* http://ssrn.com/abstract=1006118.

10. Shliefer & Vishny, *supra* note 3, at 738 ("While we agree that product market competition is probably the most powerful force toward economic efficiency in the world, we are skeptical that it alone can solve the problem of corporate governance.").

11. René M. Stulz, *Globalization, Corporate Finance, and the Cost of Capital*, 12 J. APPLIED CORP. FIN. 8, 13–15 (1999).

strand finds that better corporate governance is exogenous (or generated from outside).[12] A second strand suggests that better corporate governance is endogenous (or produced from within).[13] Given the disagreement between the exogenous or endogenous nature of good governance, there is not clear causation that good corporate governance leads to better performance. We tend to believe causation as a matter of faith rather than as a matter of evidence. This Article assumes that better corporate governance will improve corporate performance. Given this assumption, important differences emerge in terms of the incentives and structures of SOEs and private firms, which lead to dissimilar outcomes in corporate governance and efficiency.

In itself, the lack of effective corporate governance would not be fatal if antitrust law remedied some of the SOE anti-competitive distortions. However, a review of antitrust decisions across jurisdictions on the issue of predatory pricing by SOEs reveals that antitrust law is equally ineffective in its attempts to monitor SOE bad behavior.[14] This Article does not suggest that better corporate governance will necessarily cure the type of anti-competitive behavior that antitrust remedies. Rather, it makes the point that SOEs, from a standpoint of efficiency, create problems and that improved corporate governance or effective competition policy are substitutes that could lead to more efficient outcomes regarding SOEs.

12. Bernard Black, *The Corporate Governance Behavior and Market Value of Russian Firms*, 2 EMERGING MARKETS REV. 89 (2001); Art Durnev & E. Han Kim, *To Steal or Not to Steal: Firm Attributes, Legal Environment, and Valuation*, 60 J. FIN. 1461, 1487–89 (2005); Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 AM. ECON. REV. 96, 97–98 (1998); Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293, 311–14 (1988).

13. Audra L. Boone, Laura Casares Field, Jonathan M. Karpoff & Charu G. Raheja, *The Determinants of Corporate Board Size and Composition: An Empirical Analysis*, 85 J. FIN. ECON. 66 (2007); N.K. Chidambaran, Darius Palia & Yudan Zheng, *Does Better Corporate Governance 'Cause' Better Firm Performance?* (Whitcomb Ctr. for Research in Fin. Servs., working paper series WCRFS: 06–19, 2006), *available at* http://business.rutgers.edu/download.aspx?id=1192; John E. Core, Wayne R. Guay & Tjomme O. Rusticus, *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655 (2006); Harold Demsetz & Belén Villalonga, *Ownership Structure and Corporate Performance*, 7 J. CORP. FIN. 209, 211, 230–31 (2001).

14. The tax literature suggests that better corporate governance means that firms are less likely to engage in aggressive tax strategies. *See* Nicola Sartori, *Corporate Governance Dynamics and Tax Compliance*, 1, 20 (Univ. of Mich. Law Sch. Law and Econ., working paper No. 1361895, 2008), *available at* http://ssrn.com/ abstract=1361895.

Predatory pricing is only one of the anti-competitive behaviors in which SOEs engage. However, it is an area that illustrates a gap between how laws generally apply to all firms without taking into account the different dynamics between private and state ownership. This Article does not make the claim that good corporate governance will prevent antitrust violations.[15] The linkage between corporate governance and antitrust is more indirect. Both are possible legal/regulatory tools to address SOE inefficiencies.[16]

Because of the inability to obtain quantitative data to determine the full extent of the costs of SOEs worldwide, this Article employs a qualitative rather than quantitative research method. In such circumstances, a case-study approach may be the most effective way to ground analysis in experience rather than mere theory.[17] This Article uses multiple qualitative case studies to illustrate the impact of the difficulty of applying corporate governance and antitrust laws to address anti-competitive behavior by SOEs. Case studies provide an explanatory theory that has high construct validity and accommodates complex causal relations. Multiple case studies provide for more meaningful comparisons across cases and for better generalizations.[18] This Article focuses on the United States experience in greater detail to better contrast it with both common and civil law jurisdictions around the world. Furthermore, it undertakes a study of the postal sector as an SOE industry for three reasons: (1) a majority of postal providers around the world remain in state hands, (2) the postal sector is a network industry with significant competition issues, and (3) there are related services where there is competition so that the governance and competition in the postal sector affects a number of critical areas in the economy. In many countries, government ownership of postal providers has shielded the postal sector from both effective regulatory and antitrust review. The historically large role that the postal service has played in

15. But see Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 129–31 (Del. 1963) (involving a now superseded oversight case regarding the potential liability of directors for losses due to non-compliance with antitrust law).

16. However, antitrust and other violations might be more likely than with bad corporate governance in which directors are reckless.

17. GARY KING, ROBERT O. KEOHANE & SIDNEY VERBA, DESIGNING SOCIAL INQUIRY: SCIENTIFIC INFERENCE IN QUALITATIVE RESEARCH 67 (1994).

18. Christopher H. Achen & Duncan Snidal, *Rational Deterrence Theory and Comparative Case Studies*, 41 WORLD POL. 143, 146 (1989). A danger of case studies is the possibility of selection bias.

government and the economy accounts for part of the reason it has been shielded. If postal providers (and their various non-postal subsidiaries such as insurance, banking, and express delivery service companies) were to be publicly traded in their country, they would be among the largest publicly-traded firms in their respective stock markets based on market capitalization and revenues. In numerous countries, the postal regulator holds a cabinet-level position.[19] The examination of the regulation of corporate governance and of competition policy of postal firms supports the larger theoretical claim about the weaknesses of SOE governance and competition across legal origins.

Section II provides an analysis of the difference between public (government) and private (generally publicly listed) ownership in terms of incentives and mechanisms of control of corporate governance. Section III provides an understanding of the underlying economics of the postal sector. Section IV offers a review of corporate governance of postal SOEs. Section V analyzes the competition policy in those same countries and analyzes predatory pricing tests that could limit the potential anti-competitive harm that SOEs might create. Section VI concludes and offers a series of recommendations on improved corporate governance and competition law and policy of SOEs, regardless of the legal origin.

II. PRIVATE VS. GOVERNMENT CONTROL OF FIRMS

A. Setting the Stage

SOEs are, as the name suggests, controlled by the state rather than by private actors. This Article uses the World Bank definition for an SOE: "government owned or government controlled economic entities that generate the bulk of their revenues from selling goods and services."[20] According to a number of empirical

19. This for a time was also true in the United States, where the Postmaster General was a cabinet-level position. John C. Panzar, *Interactions between Regulatory and Antitrust Policies in a Liberalized Postal Sector*, 2 (Aug. 22, 2009) (unpublished manuscript), *available at* http://www.econ.canterbury.ac.nz/research/pdf/Paper_Panzar.pdf.

20. WORLD BANK, BUREAUCRATS IN BUSINESS: THE ECONOMICS AND POLITICS OF GOVERNMENT OWNERSHIP 26 (1995) (drawing from Leroy Jones, Public Enterprise and Economic Development: The Korean Case (1975) (thesis, Harvard Univ.) (on file with Korea Development Institute)).

studies, SOEs tend to be less efficient than similar private firms because of the incentives associated with government ownership.[21]

SOEs are an important part of global economic activity but remain under-explored in the academic literature, particularly the legal literature. Recent empirical work associates SOEs with lower economic growth in the developing world.[22] "[S]potty and relatively old data" hamper systematic analysis of current trends in SOE involvement in the economy.[23] Nevertheless, recent work by the World Bank concludes that SOEs play a critical role in the economy, particularly in the Middle East, Africa and Asia.[24] SOEs are part of a larger set of issues regarding state control over the economy. In Eastern Europe and the former Soviet Union, the public sector share of GDP varies from as little as around twenty percent (Czech Republic, Slovakia and Hungary) to as much as eighty percent (Belarus). Twenty of twenty six transition countries were in the range of twenty to forty percent of GDP for the state sector share of GDP.[25] These numbers do not reflect changing developments

21. *See, e.g.*, WILLIAM L. MEGGINSON, THE FINANCIAL ECONOMICS OF PRIVATIZATION (2005); La Porta et al., *supra* note 4, at 267–68; Wei Li & Lixin Colin Xu, *The Political Economy of Privatization and Competition: Cross-Country Evidence from the Telecommunications Sector*, 30 J. COMP. ECON. 439 (2002). *But see*, Daniel F. Spulber, *Discovering the Role of the Firm: The Separation Criterion and Corporate Law*, 16 (N.W. Law & Econ., Research Paper No. 08-23, 2008) (going so far as to refuse to classify SOEs as firms since there is no separation between the transactional interests of the firm and its owners).

22. Allen N. Berger, Iftekhar Hasan & Mingming Zhou, *Bank Ownership and Efficiency in China: What Will Happen in the World's Largest Nation?*, 1 (Working Paper, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=924246.

23. Sunita Kikeri & Aishetu Fatima Kolo, *Privatization Trends and Recent Developments*, 15 (World Bank Policy Research, Working Paper No. 3765, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849344. A World Bank study estimated that worldwide, SOEs account for between eight to ten percent of GDP in countries that are classified as either upper-middle-income or industrialized. In low income countries, SOEs account for a fourteen percent share in GDP. WORLD BANK, *supra* note 20, at 32–33. There are problems to the methodology of this report including the selection of certain sectors for study and the countries picked. *See generally* Ravi Ramamurti, *Why Haven't Developing Countries Privatized Deeper and Faster?*, 27 WORLD DEV. 137 (1999).

24. Sunita Kikeri & Aishetu Kolo, *State Enterprises*, WORLD BANK PUB. POL'Y J. 304 (2006), *available at* http://rru.worldbank.org/PublicPolicyJournal/Summary.aspx?id=304 (noting the prevalence of SOEs around the world); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *The Quality of Government*, 15 J.L. ECON. & ORG. 222, 261–62 (1999) (noting that SOEs are more common in countries which have a French civil code or Socialist legal origin).

25. World Bank, ECONOMIES IN TRANSITION: AN OED EVALUATION OF WORLD BANK ASSISTANCE 15 (2004).

around the world where financial crisis has caused a number of countries to nationalize some struggling firms.

The prevalence of SOEs around the world and the outcomes of SOE behavior may cause a resource misallocation in society. As this Article will discuss in greater detail, government ownership may facilitate rent-seeking behavior by interest groups to undertake certain types of state support through regulatory mission creep and through increased regulatory barriers to entry. Government ownership adds to inefficiency and increases transaction costs.[26] Such barriers to entry may have a significant negative effect on a country's economy given the critical role the private sector plays in a country's global competitiveness.[27]

That SOEs exist at all and that they exist in such large numbers is perhaps surprising. After all, as recently as 2001, Hansmann and Kraakman suggested that we had reached the end of history for corporate law[28] because of worldwide convergence based on a number of factors:

> (1) full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm, as distinct from the firm's owners; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.[29]

According to their analysis, there was little appeal to a heavy-handed state in corporate affairs.[30] However, SOEs have not followed the path toward global convergence in corporate law, even before the current period of global financial crisis.

In one sense, Hansmann and Kraakman are correct about an end of history of corporate law. SOEs are outliers. They are less efficient than private firms. Empirical work suggests that when benchmarked

26. Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AMER. ECON. REV. 291 (1974).

27. *See* Ziya Öni, *The Logic of the Developmental State*, 24 COMP. POL. 109, 124–25 (1991).

28. This is a take-off on Kant's idea of the end of history and on the best-selling book from the 1990s, FRANCIS FUKUYAMA, THE END OF HISTORY AND THE LAST MAN (1992) (arguing that liberal-democracy had won in the marketplace of ideas).

29. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–40 (2001).

30. *Id*. at 447.

against similar private firms, SOEs perform worse.[31] Yet, in spite of the end of history for corporate law as articulated by Hansmann and Kraakman, we live in a world full of SOEs. In fact, due to the worldwide financial crisis, the number of SOEs around the world seems to be increasing. Therefore, scholars need to address how to improve the effectiveness of SOEs.

A series of studies suggest that a relatively modest improvement in the efficiency of SOEs of five percent in a given country could free up financial resources of approximately one to five percent of a country's GDP.[32] Conversely, if an SOE is poorly managed, it can increase the cost to governments and divert money from other priorities.

This is not a simple dichotomy. The market does not always send the right signals and may malfunction. If we assume that the current financial crisis is merely a blip, then the market is in fact still better relative to the alternatives. We need to think about alternatives, specifically about SOEs in sectors that are competitive (or can be) and that have network effects.[33]

31. Alvaro Cuervo & Belén Villalonga, *Explaining the Variance in the Performance Effects of Privatization*, 25 ACAD. MGMT. REV. 581, 581–83 (2000) (noting that privatized firms perform better but with variable performance); Florencio López-de-Silanes, *Determinants of Privatization Prices*, 112 Q.J. ECON. 965, 967–68 (1997); William L. Megginson, Robert C. Nash & Matthias van Randenborgh, *The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis*, 49 J. FIN. 403, 403–05 (1994); Belén Villalonga, *Privatization and Efficiency: Differentiating Ownership Effects from Political, Organizational, and Dynamic Effects*, 42 J. ECON. BEHAV. & ORG. 1, 43 (2000) (providing a literature review of 153 studies on privatization).

32. Maria Vagliasindi, *Governance Arrangements for State Owned Enterprises*, 2 (World Bank Policy Research, Working Paper No. 4542, 2008).

33. Are market-based metrics right for judging SOEs? This question is worthy of a book of its own. This Article does not address all SOEs. There are some that have important security, market failure, or altruistic functions. This Article only addresses those SOEs for which there is a market competition function rather than a market replacement function. The proposals at the end of the Article are general and need to be contextualized to the specific situation in a given country based on political, social, and economic factors. This Article does not address other ways to think about the role of regulation and the limits of market as opposed to other non-market approaches and the extent to which some SOEs might be seen as public goods. For this Article, the concern is only for those functions which are also privately provided and where issues of civics, prestige, and altruism play a marginal role for SOEs as opposed to other goods and services provided by the state.

B. Firms Generally

Before identifying the special characteristics of SOEs, let us begin with a basic overview of the purpose of a firm and of corporate law. Private firms exist to make a profit. From a contract theory standpoint, Easterbrook and Fischel suggest that firm owners contract to maximize wealth.[34] Though a number of scholars suggest that profit making, both as a matter of positive and normative law does not require profit maximization,[35] the profit making component for firms remains the central component for doing business, even if not the only motive. To achieve a profit making result, law provides for the allocation of residual ownership of the corporation to shareholders.

Corporate law is the body of rules that allow for the creation and continuation of the corporate form and for profit creation.[36] Corporate governance addresses the governance mechanisms of the firm.[37] The first issue that we must address in corporate governance is definitional—what do we mean by corporate governance? For purposes of this Article, let us define corporate governance as "the system of laws, rules, and factors that control operations at a company."[38] Jean Tirole explains that, from an economics perspective,

> corporate governance relates to the "ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment." Moreover, [corporate governance] is preoccupied with ways in which a corporation's insiders can

34. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1421 (1989).

35. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 738–40 (2005) (arguing that pure profit maximization would reduce quality of corporate governance because it would override social and moral sanctions); Cynthia A. Williams, *A Tale of Two Trajectories*, 75 FORDHAM L. REV. 1629, 1632–33 (2006) (suggesting that human rationality and cognitive behavior allow for a more nuanced understanding of the process of compliance with law).

36. *See* D. Gordon Smith, *Response: The Dystopian Potential of Corporate Law*, 57 EMORY L.J. 985, 990 (2008).

37. For literature reviews on corporate governance, see Shleifer & Vishny, *supra* note 3; Klaus Gugler, Dennis C. Mueller & B. Burcin Yurtoglu, *Corporate Governance and Globalization*, 20 OXFORD REV. ECON. POL'Y 129 (2004).

38. Stuart L. Gillan, *Recent Developments in Corporate Governance: An Overview*, 12 J. CORP. FIN. 381, 382 (2006).

> credibly commit to return funds to outside investors and can thereby attract external financing.[39]

The traditional problem of corporate governance in the United States is a vertical problem among shareholders, managers, and directors.[40] In contrast, given more highly concentrated ownership in the rest of the world, oftentimes the major issue of control is horizontal among controlling shareholders and outside shareholders.[41]

One issue that arises in corporate governance is the problem of agency costs.[42] These costs occur because the separation of ownership from management creates manager incentives that may be different from those of shareholders.[43] There are sub-principal-agent situations within a firm at each level of management, and agency costs can arise at each of these levels.[44] Jensen and Meckling created an agency cost model of delegation of decision-making authority from the principal to the agent.[45] Fama and Jensen suggested that agency costs could include "structuring, monitoring, and bonding a set of contracts among agents with conflicting interests."[46] In the corporate setting, the most important agency cost is the cost of monitoring agents by the principal. These costs are not imposed merely through direct monitoring. Rather, monitoring costs also include various mechanisms by the principal "to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc."[47] These mechanisms work to align

39. JEAN TIROLE, THE THEORY OF CORPORATE FINANCE 16 (2006).

40. *See* Mark J. Roe, *The Institutions of Corporate Governance*, *in* HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 372 (Claude Menard & Mary M. Shirley eds., 2004).

41. *See id.*

42. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976).

43. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119–25 (Macmillan Co. 1939) (1932); Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 231–32 (2008).

44. *See* Jensen & Meckling, *supra* note 42, at 309.

45. *Id.* at 308–10.

46. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

47. Jensen & Meckling, *supra* note 42, at 308 n.9. Some think that the emphasis on agency costs underplays the importance of team production that requires inputs from various stakeholders. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Director Accountability and the*

incentives of the principal and agent to reduce agency costs. Without such mechanisms to align the incentives between the two groups, managers may attempt to shirk from their duties or steal from the corporation.

Shirking is particularly troublesome in the agency context because it is difficult to prove—it is easier to prove that someone is stealing rather than shirking (e.g., lack of oversight, care, etc.).[48] As each individual investor has a high cost to monitor to prevent managerial shirking, it can be quite expensive to monitor a firm for any particular investor.[49] Alchian and Demsetz provide the insight that the purpose of management is to monitor the various outputs of agents to deter shirking.[50] To prevent managers themselves from shirking, the shareholder as residual claimant provides oversight over managers and directors.[51]

To control agency costs, firms often use a nexus of contracts.[52] In the contractual theory of the firm, the firm as a legal entity is based upon a set of contracts within the common framework of the

Mediating Role of the Corporate Board, 79 WASH. U. L.Q. 403, 403–05 (2001); Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 743–45 (1999).

48. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (arguing that individuals have incentive to shirk in their duties to the firm); Roy Radner, *Hierarchy: The Economics of Managing*, 30 J. ECON. LITERATURE 1382, 1405–07 (1992) (providing an account for rational agents to shirk).

49. Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45, 46 (2004) (noting that "[t]hrough the expenditure of costly resources, any single investor may monitor and work to discipline underperforming managers," but that any one investor lacks the incentive to provide the optimal level of such monitoring).

50. Alchian & Demsetz, *supra* note 48, at 781–82.

51. For example, shareholders as owners have the power to approve major transactions and to replace directors. Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1439–40 (2006). According to Bainbridge, such a solution has a number of shortcomings because it fails to recognize the reality of shareholder supremacy. As Bainbridge states, "[i]n general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents." Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 568 (2003).

52. *See* Joanna M. Shepherd, Frederick Tung & Albert H. Yoon, *What Else Matters for Corporate Governance?: The Case of Bank Monitoring*, 88 B.U. L. REV. 991, 994–95, 1001–09 (2008); D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1057–59 (1996) (discussing the contractarian model). Note however that agency costs and the contractarian model are distinct.

firm.[53] The contracts that make up the firm address a number of issues such as the source of financing, the nature of residual ownership interests in the firm and the division of responsibilities with the firm.[54] The key insight of the contractual theory of the firm is that through contracts, a firm can reduce risks and create incentives for management and employees of a firm.[55] Yet, contracts are not sufficient because of the potential self interest of management. This is why statutes and equity were needed to set forth basic principles of corporate governance.

C. SOEs Generally

SOEs are different from privately-owned firms. SOEs are not necessarily profit maximizers,[56] they may have goals that conflict with those of their de facto owners—the government,[57] they do not necessarily seek to maximize shareholder value,[58] and they may be playing on an unlevel playing field relative to their private counterparts.[59] All of these factors play some role in reducing SOE efficiency, and limiting the success of SOEs relative to private corporations.[60]

SOEs are different from private firms because SOEs are not necessarily profit-maximizers.[61] Some (or in a number of cases, all) SOE functions may be based on non-financial goals. One potential problem with state ownership is that it may be used for political

53. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–39 (1991).

54. R. Richard Geddes, *Agency Costs and Governance in the United States Postal Service*, *in* GOVERNING THE POSTAL SERVICE 114, 116 (Gregory J. Sidak ed., 1994).

55. FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (Univ. of Chi. Press 1971) (1921) (addressing how contracting can reduce certain types of risk); Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance & Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 133–35 (2001) (arguing that incentive-based compensation serves as an internal governance mechanism); Jensen & Meckling, *supra* note 42, at 305–10 (arguing the firm is a nexus of contracts).

56. *See infra*, notes 62–71 and accompanying text.

57. *See infra*, notes 72–76 and accompanying text.

58. *See infra*, note 77 and accompanying text.

59. *See infra*, notes 78–79 and accompanying text.

60. *See infra*, notes 80–83 and accompanying text.

61. Michael J. Trebilcock & Edward M. Iacobucci, *Privatization and Accountability*, 116 HARV. L. REV. 1422, 1426–27 (2003).

objectives. Some objectives for SOEs may include employment,[62] social goals,[63] or capital formation.[64] This is not to suggest there are not some situations in which SOEs should play a role in the economy.[65] The most persuasive defense of state ownership arises when state ownership overcomes market failure.[66] There also may be a need for intervention for social reasons to redistribute to the very poor.[67] Moreover, SOEs may be desirable if a public good needs to be provided and if quality is difficult to specify in a contract.[68] These goals, however, for the most part, are not based upon an efficiency rationale.

Government may have competing goals and SOE management has to determine which of these goals to follow.[69] Moreover, government interests may not be the same as commercial interests. As a result of this tension, government may not provide the necessary oversight function for an SOE. The lack of effective oversight may result in part from situations in which a number of different parts of government oversee the SOE.[70]

Some SOEs may not focus on profit maximization because they are in regulated industries in which regulators pressure firms to undertake certain policies with outcomes to benefit politicians rather

62. Maxim Boycko, Andrei Shleifer & Robert W. Vishny, *A Theory of Privatisation*, 106 ECON. J. 309, 309 (1996).

63. Ronald Wintrobe, *The Market for Corporate Control and the Market for Political Control*, 3 J.L. ECON. & ORG. 435, 435–36 (1987).

64. Armando Labra, *Public Enterprise in an Underdeveloped and Dependent Economy*, *in* PUBLIC AND PRIVATE ENTERPRISE IN A MIXED ECONOMY 36, 36–37 (William J. Baumol ed., 1980).

65. *See, e.g.*, David E. M. Sappington & Joseph E. Stiglitz, *Privatization, Information, and Incentives*, 6 J. POL'Y ANALYSIS & MGMT. 567, 567 (1987).

66. Paul A. Grout & Margaret Stevens, *The Assessment: Financing and Managing Public Services*, 19 OXFORD REV. ECON. POL'Y 215, 215 (2003).

67. Andrei Shleifer, *State Versus Private Ownership*, 12 J. ECON. PERSP. 133, 135 (1998) (public ownership may be preferred "in a country [where] good contract enforcement [is] very limited, and [in] particular cases where soft incentives are extremely valuable and competition is very limited").

68. *See* Timothy Besley & Maitreesh Ghatak, *Government Versus Private Ownership of Public Goods*, 116 Q.J. ECON. 1343, 1343–45 (2001).

69. Where a sector ministry provides regulatory oversight and another ministry exercises financial oversight, this may reduce the intra-government conflict of interest.

70. David H. Scott, *Strengthening the Governance and Performance of State-Owned Financial Institutions* 7–8 (World Bank Pol'y Research, Working Paper No. 4321, 2007).

than shareholders.[71] Government must balance its role as regulator with its role as the owner of a firm. Bureaucrats may have an incentive to protect SOEs from competition when bureaucrats serve as both regulators and market participants. Bureaucrats also have an incentive to increase the size of bureaucracy (such as an SOE) because the increased size and scope of a bureaucracy provides them with greater prestige and the ability to advance their careers.[72]

The lack of an efficiency rationale changes the incentives for an SOE. Since SOEs lack shareholders because they are owned by the government, the ultimate shareholder equivalent in an SOE is the country's citizens. Yet, there is a potentially significant agency cost problem in the arrangement in which citizens' interests are not aligned with SOE management, directors, and regulatory overseers. Behavior of firms in state hands will be less aligned with owner welfare because the types of incentives used to align behavior that the market provides are either non-existent or more limited when dealing with SOEs.

Owners do not have direct ownership rights in the SOE. Therefore they do not receive the proceeds of the firm. Unlike ownership rights in private firms, there is a restricted ownership right in SOEs. Transferability of shares in private firms means that there is exit by shareholders dissatisfied with managerial decision-making. This is also an important control mechanism, as a lower share price creates a threat to management through the market for corporate control, which SOEs do not face, as this Article will discuss. The fundamental principal-agent in the SOE context is one that "exists between taxpayers and the government rather than between the owner, which is actually the government, and the SOEs."[73] Thus, this relationship leads to higher agency costs than would exist with management and owners of private firms. The various internal and external mechanisms that limit agency cost problems in private firms

71. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990) (suggesting that political pressure affects firm decision-making).

72. Andre Blais & Stephane Dion, *Conclusion: Are Bureaucrats Budget Maximizers*, *in* THE BUDGET-MAXIMIZING BUREAUCRAT: APPRAISALS AND EVIDENCE 355 (Andre Blais & Stephane Dion eds., 1991); WILLIAM A. NISKANEN, BUREAUCRACY AND PUBLIC ECONOMICS (1994).

73. Yoichi Takahashi, *Does Discipline by SOE Bonds Work?—Japan's Experience with Zaito Reform* (OECD, Development Research Center of the State Council of PRC, Asian Development Bank), Jan. 18–19, 2000, at 2.

are far less effective for SOEs, as the various traditional governance mechanisms may not fit an SOE that may be unmotivated by profit.

SOEs may not exist to maximize shareholder (citizen) value. There may be noncommercial activities that an SOE pursues and potential political interference in the day-to-day management of SOEs. Worse, if the political elements of government decide SOE policy, this takes independence and authority away from the SOE board of directors. There is a growing literature in the United States on shareholder democracy and accountability of boards and management.[74] Whatever such issues exist among publicly traded firms, the accountability problems of board and management are more severe in SOEs, yet have received less attention.

Government may create an uneven playing field in those markets where an SOE competes with private firms.[75] Government has an interest in ensuring that its state owned firms succeed. As such, the government as regulator may restrict competition by providing various benefits to SOEs that it does not offer to other firms. Though this might result in direct preferences, some of the preferences might be indirect, such as implicit loan guarantees for favorable lending, regulatory preferences such as the creation of a large monopoly position in related industries, limitations on foreign ownership, or implicit subsidies through a lack of taxation or more lax corporate governance requirements vis-à-vis private firms. The nature of SOE regulation might be arbitrary where the only predictability in regulation may be that government looks to protect its SOE over all other goals.[76] High barriers to entry limit the ability of the market, through competition, to serve as a check on the poor decision-making of SOEs.

Alchian made a theoretical prediction that since private firms behaved differently than state-owned firms, the performance of each type of firm would vary, with private firms performing more successfully than state owned firms.[77] The costs of decision-making

74. *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835 (2005) [hereinafter Bebchuck, *The Case for Increasing Shareholder Power*]; Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

75. *See* Eleanor M. Fox, *An Anti-Monopoly Law for China—Scaling the Walls of Government Restraints*, 75 ANTITRUST L.J. 173, 178–79 (2008).

76. Timothy Irwin & Chiaki Yamamoto, *Some Options for Improving the Governance of State-Owned Electricity Utilities*, 7 (World Bank Energy and Mining Sector Board, Working Paper No. 11, 2004).

77. Armen A. Alchian, *Some Economics of Property Rights*, 30 IL POLITICO 816 (1965).

remain less concentrated in private firms than in SOEs and there is more accountability in private firms based on the outcome of such decisions. It is more difficult to constrain public actors than private ones because there is less accountability for making a mistake. Indeed, there is a risk that management may not have an accurate sense of the organizational structure of an SOE (more than of a private firm) because of greater principal-agent problems. An SOE may have many subprincipal agent problems because of what may be an overly complex chain of command. This reduces accountability, especially when there are multiple principals (assuming that one can always identify the principals). Managers in SOEs are less likely to be fired by the board for making a bad decision and the state is more likely to bail out a mismanaged SOE. From a theoretical standpoint, we should expect to see improved performance of a private firm because the incentives between management and shareholders will be better aligned for improved performance in firms.[78] Empirical work on the difference in performance between state-owned and privatized firms confirms this theoretical insight.[79] For example, Shirley and Walsh in their literature review found that among fifty-two studies they surveyed, in only five of the fifty-two studies did SOEs outperform private firms.[80]

D. Internal Controls

1. Corporations

Firms use internal controls to reduce agency cost problems. Internal controls include managerial participation in ownership, rewards for management, and the use of the board of directors for oversight. These internal controls somehow affect firm performance positively. A number of studies attempt to construct indices of the quality of corporate governance at the firm level just as LLSV literature has tried to do at the country level. The three important

78. Carl Shapiro & Robert D. Willig, *Economic Rationales For the Scope of Privatization*, *in* THE POLITICAL ECONOMY OF PUBLIC SECTOR REFORM AND PRIVATIZATION 55, 55–56 (Ezra Suleiman & John Waterbury eds., 1990); Jean-Jacques Laffont & Jean Tirole, *Privatization and Incentives*, 7 J.L. ECON. & ORG. 84, 87–88 (1991) (explaining the conventional wisdom in comparing privately-run and publicly-run enterprises); Sappington & Stiglitz, *supra* note 65, at 567.

79. Villalonga, *supra* note 31, at 43.

80. Mary M. Shirley & Patrick Walsh, *Public versus Private Ownership: The Current State of the Debate*, 51 (World Bank Policy Research, Working Paper No. 2420, 2001).

firm level indices of the quality of governance are (a) Gompers, Ishii, and Metrick;[81] (b) Bebchuk, Cohen, and Ferrell;[82] and (c) Brown and Caylor.[83] Each of these indices associates good corporate governance with good corporate performance.[84] However, studies that link good corporate governance to strong corporate performance, for the most part, come up short.[85] In terms of the causality of good governance and corporate performance, perhaps none of the indices are satisfactory. In an important work that reviews the strengths and weaknesses of the firm level corporate governance indices, Bhagat, Bolton, and Romano conclude, "In short, there is no one 'best' measure of corporate governance: the most effective governance institution appears to depend on context, and on firms' specific circumstances."[86] This suggests that governance may be endogenous to the firm's characteristics.

Undertaking an analysis of individual corporate governance controls is somewhat risky because the empirical literature is inconclusive at best.[87] The present Article is more modest in its claims about corporate governance and corporate performance. It describes within one particular industry sector in which there are many SOEs across countries, how corporate governance mechanisms may be limited in effectiveness. Given that these firms are not publicly traded, it is more difficult, from the standpoint of data collection, to prove that these are well or not well run firms. Even if one could collect the data successfully, there might be significant endogeneity problems that would limit any conclusions that one could draw about SOE governance.

81. Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

82. Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?* 22 REV. FIN. STUD. 783 (2009).

83. Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, 25 J. ACCT & PUB. POL'Y 409 (2006).

84. *Id.*; Gompers, Ishii, & Metrick, *supra* note 81; Bebchuk, Cohen, & Farrell, *supra* note 82.

85. Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 800 (2007) ("Although dozens of papers have tried to find relationships between particular governance practices and corporate performance, most fail to find any strong connection, and the few studies that do . . . often are not supported by other researchers."(internal citation omitted)).

86. Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1808 (2008).

87. *Id.* at 1814.

2. Managerial ownership and pay

Jensen and Meckling, in their seminal work on agency costs, found that increased managerial ownership led to reduced agency costs and thus increased maximization of the firm.[88] Work by other scholars yields similar conclusions.[89] Building from this insight, some scholars have qualified the role that management's ownership of a firm plays in improved firm outcomes. Too high an ownership level may reduce corporate performance because it may reduce the ability to dismiss ineffective management. Yet, some level of corporate ownership by management may increase firm performance.[90] In many cases, SOE managers do not face the types of financial rewards of private firms. SOE managers cannot be rewarded additional compensation based on an increase of the SOE's stock price.

Firms enter into contracts with management that create incentives for performance-based pay.[91] Pay incentives through contracts, if calibrated correctly, align the incentives of management to that of shareholders.[92] This is not to suggest that too generous a pay scheme might not create distortions of its own. Bebchuk and Fried are critical about overly generous management compensation. They argue that executive compensation is not the product of arm's length bargaining between managers and the board to maximize

88. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

89. John J. McConnell & Henri Servaes, *Equity Ownership and the Two Faces of Debt*, 39 J. FIN. ECON. 131 (1995); Eric R. Gedajlovic & Daniel M. Shapiro, *Management and Ownership Effects: Evidence from Five Countries*, 19 STRATEGIC MGMT. J. 533 (1998); Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101 (1991).

90. Randall Morck, Andrei Shleifer & Robert Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. ECON. 293 (1988).

91. Kevin J. Murphy, *Explaining Executive Compensations: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 850 (2002) (questioning the managerial power hypothesis by noting that "CEOs hired from the outside with no ties to the existing board enjoy especially attractive pay packages . . . ."); *see also* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569 (2001).

92. Guido Ferrarini & Niamh Moloney, *Executive Remuneration in the EU: The Context for Reform*, 21 OXFORD REV. ECON. POL'Y 304 (2005).

shareholder value.[93] Nevertheless, even such critics do not oppose the use of incentive pay, in principle.[94]

It is possible to create incentive based compensation for SOEs. However, SOE incentives are different from private firms in that the choice of managers may be made on a political basis rather than merit. Moreover, the goals based upon the incentives may not be profit based. Perhaps this explains why in the SOE context, these incentive contracts have not met with success.[95] This is not surprising as, theoretically, such compensation in SOEs will be less effective because it will be, by nature, less based on market outcomes than private firms.[96]

Data from recently privatized firms shows that managerial pay increases post-privatization significantly, even when the managers are the same.[97] The explanation for these findings is that there is a high correlation of the increase in salary and potential profits of the firms.[98] From this, one might conjecture that SOE managers actually have reason to maximize their budget rather than efficiency for much the reason that other bureaucrats do—to increase their power.[99]

93. Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 764–74 (2002).

94. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 189–90 (2006).

95. Mary M. Shirley & Lixin Colin Xu, *The Empirical Effects of Performance Contracts: Evidence from China* (World Bank, Dev. Research Group, Policy Research Working Paper no. 1919, 1998); Mary M. Shirley & Lixin Colin Xu, *Information, Incentives, and Commitment: An Empirical Analysis of Contracts between Government and State Enterprises* (World Bank, Dev. Research Group, Policy Research Working Paper no. 1769, 1997).

96. Trebilcock & Iacobucci, *supra* note 61, at 1428. Political constraints play a role to limit the pay of management in regulated industries. Paul L. Joskow, Nancy L. Rose & Catherine D. Wolfram, *Political Constraints on Executive Compensation: Evidence from the Electric Utility Industry*, 27 RAND J. ECON 165 (1996). In some settings, this may suggest that inefficiencies will exist in both SOEs and private firms in regulated industries will negate ownership effects. R. Richard Geddes, *Ownership, Regulation, and Managerial Monitoring in the Electric Utility Industry*, 40 J.L. & ECON. 261, 284 (1997) ("Controlling for firm size, managers in government utilities do not have longer tenure in their jobs than their counterparts in private firms.").

97. Catherine D. Wolfram, *Increases in Executive Pay Following Privatization*, 7 J. ECON. & MGMT. STRATEGY 327 (1998).

98. *Id.*

99. WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36–42 (1971) (explaining the budget maximizing behavior of bureaucrats).

3. Board oversight

A firm has a board of directors rather than an executive who rules by fiat because deliberation of a group with complementary skills and oversight duties *should* lead to better business outcomes. The board serves to monitor managers on behalf of shareholders. In theory, the board protects shareholders from potentially risky and costly managerial mistakes in strategy. The board also provides oversight to ensure that management does not shirk its responsibilities. Some work suggests that independent board oversight is central to ensure that managers do not receive overcompensation for their work.[100]

Just as manager-shareholder incentives may not be aligned, director-shareholder incentives likewise may not be aligned. One way to reduce the director-shareholder misalignment is through equity-based compensation for directors. Empirical evidence suggests that this approach has been effective in aligning the interests of outside directors with shareholders in certain circumstances.[101] This is not to suggest that it is effective in all circumstances, but that given the right amount of incentives (not too much and not too little), equity can align the incentives of directors and shareholders.

Diffuse ownership of shares may present some problems in terms of organizing shareholders to reduce the agency costs of ownership. Monitoring costs may be high because of diffuse ownership. This may allow management to co-opt directors. Shareholders may remain passive in their ownership because of the high cost of monitoring and potential for free riding off of the work of other

100. Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); *see* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 453–55 (1988); Benjamin E. Hermalin, *Trends in Corporate Governance*, 60 J. FIN. 2351, 2371 (2005) ("[I]t is possible that average CEO compensation is higher at firms with less diligent boards."). *But see* David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996) (finding an inverse association between the fraction of outside directors and Tobin's Q).

101. Mine Ertugrul & Shantaram Hegde, *Board Compensation Practices and Agency Costs of Debt*, 14 J. CORP. FIN. 512, 529–30 (2008) (finding that stock and option compensation for outside directors is more effective than cash in terms of creating effective monitoring incentives); Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229 (2005) (finding in a sample of Fortune 1000 firms that those firms that have outside director options have significantly higher market to book ratios and profitability metrics than those without outsider director options).

larger shareholders. However, corporate law has certain protections for minority shareholders.[102]

There is criticism about the director-centric approach to corporate law.[103] Bebchuck has articulated concern that a board of directors may not use its powers to maximize the well-being of shareholders.[104] Even if Bebchuk is correct—if we take the claim seriously that institutional investor activism can provide increased shareholder control[105]—then SOE governance is particularly problematic. There is near nonexistent shareholder equivalent activism in SOEs. There are no institutional investors that can push for greater voice for shareholders. That is, in SOEs, the voice of any shareholder equivalent (a voter) cannot easily be aggregated the way that institutional investors can aggregate votes because of collective action problems.[106] The organizational costs of most SOEs are larger because it is more difficult to fire people in government than in private firms—SOEs are less responsive to market forces.

Other factors distinguish corporate governance of SOEs. Property rights in private firms are transferable. An SOE lacks such transferability. The only way that SOE shareholder equivalents can vote with their feet is indirectly through national elections, where a new party might impose a different set of priorities for SOEs. The effect is a disconnect between present behavior and future outcome that a listed stock provides nongovernment owned firms. Because of the non-transferability of ownership, there is less incentive to monitor because the principal cannot create more value that she can then capture through a sale of the ownership stake.[107] Without effective monitoring, it is easier for managers in SOEs to make poor decisions because of a lack of accountability for the consequences of

102. Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119 (2003); Bernard S. Black, *Shareholder Passivity Re-examined*, 89 MICH. L. REV. 520 (1990).

103. KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2006).

104. Bebchuck, *The Case for Increasing Shareholder Power*, *supra* note 74, at 910.

105. Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007); Bebchuck, *The Case for Increasing Shareholder Power*, *supra* note 74; *see* Lisa Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53 (2008).

106. *See generally* MANCUR OLSON, THE LOGIC OF COLLECTION ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (Harvard Univ. Press 1971) (1965) (explaining collective action problems).

107. Louis De Alessi, *The Economics of Property Rights: A Review of the Evidence*, *in* 2 RESEARCH IN LAW AND ECONOMICS 27–28 (Richard O. Zerbe, Jr. ed., 1980).

such decisions. SOE managers and directors do not face repercussions such as termination for poor decision making.[108]

E. External Controls

External controls refer to elements outside of the firm that limit agency costs of managers. Such exogenous elements include the market for corporate control, the equity market, the bond market, the market for managers, and bankruptcy.

1. Market for corporate control

Henry Manne first identified the market for corporate control.[109] Managers may be replaced through takeovers. If management decision making is poor, this will be reflected in a depressed stock price for the firm. If management is ineffective, the stock price of the corporation should fall. A lower stock price due to poor management is an invitation for a potential takeover. A takeover is more likely because the corporation can be bought on the cheap.

The possibility of takeover via a hostile acquisition such as a tender offer or proxy contest creates incentives for managers within the firm. These incentives discipline managerial behavior. In a takeover, the new owners are likely to replace poorly performing managers. Conversely, if management performs well, the stock price of the corporation is more likely to rise. This will reduce the possibility of takeover of the corporation because the cost of shares increases, which reduces the difference between the potential arbitrage of current versus potential share price.[110] Managers, therefore, should keep their jobs when they perform well.

The theory of the market as a corporate control has been supplemented by empirical work. An unwise acquisition bid by management can have a negative effect on an acquirer, including the

108. Except perhaps in authoritarian regimes where bad decision making by executives of SOEs might lead to imprisonment or firing squad.

109. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

110. JONATHAN MACEY, CORPORATE GOVERNANCE 119 (2008); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982) (explaining the incentives for management to avoid takeovers in the market for corporate control).

acquiring firm becoming a future target itself.[111] Nevertheless, the market for corporate control is far more limited than theory would predict. This is due to various legal mechanisms such as poison pills and staggered boards that limit the ability to undertake hostile takeovers (at least in the United States). These types of defensive mechanisms allow management to become entrenched from takeovers, which creates inefficiencies as an expense that the shareholders must bear.[112]

Though control problems will occur even in private firms, these distortions are not as severe as those of government owned firms. SOEs are not subject to the same sorts of repercussions from bad management. Because of government ownership, SOEs do not face acquisition threats from firms that may be able to unlock value from the firm through better management. Unlike private firms, SOEs do not operate under hard budget constraints. Instead, they operate under what economists term "soft" budget constraints.[113] These constraints are "soft" because another institution (in our case, another part of government) will pay the shortfall for mismanagement of the SOE. Such firms do not fear the negative consequences of bad mistakes because even a chronic loss making firm will be bailed out by the state. Managers of the SOE will expect this external financial assistance and as such, may not undertake the types of sound and profitable strategies of private firms.

2. Equity

Publicly traded shares of stock provide information on the relative state of a firm. The capital markets provide a signal about the valuation based on discounted value of profits of a firm, which is based on the current and future state of the management team and

111. Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372 (1990); Sara B. Moeller, Frederik P. Schlingemann & Rene M. Stulz, *Firm Size and the Gains from Acquisitions*, 73 J. FIN. ECON. 201 (2004).

112. JONATHAN MACEY, CORPORATE GOVERNANCE: PROMISES MADE, PROMISES BROKEN 118–126 (2008); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 88–91 (2001) (providing a literature review that supports a management entrenchment hypothesis).

113. Janos Kornai, *The Soft Budget Constraint*, 39 KYKLOS 3 (1986); Janos Kornai, Eric Maskin & Gerard Roland, *Understanding the Soft Budget Constraint*, 41 J. ECON. LIT. 1095 (2003). There are political economy reasons why soft budget constraints exist. They may keep social peace, maintain artificially high levels of employment, or respond to political needs to subsidize firms.

its decisions.[114] We assume that the market appropriately prices the value of the ownership right. Even, however, if the market does not, it is still a better indicator of the value based on performance than measures of public sector performance management. SOEs are not publicly traded, so they lack this signal of firm performance that equity markets provide.

3. Debt

Debt is a mechanism to control and measure the performance of the firm. If a firm issues debt, there are consequences on firm management. Debt reduces free cash flow. This disciplines management because there is less money to spend due to the need to service the debt. There is also a signaling function to debt. Firms that are poorly managed and are in financial difficulty will have a poor debt rating. If a firm has a poor debt rating, it will be more expensive for a firm to borrow money since the rating will reflect the possibility that the debt may not be repaid. Banks frequently review credit decisions. Moreover, a credit rating agency such as Moody's and Standard & Poor's ("S&P") rate borrowers and update such ratings. These regular recalibrations in the market for debt send a signal about the health of a given firm. If a firm's rating were to deteriorate, it would signal to the market that the firm has undertaken harmful decisions that have increased firm risk.

There are limits to the amount of trust to place in credit rating agencies as gatekeepers to promote better corporate behavior.[115] Subprime mortgages are one such example of the limits. Rating agencies may serve as ineffective gatekeepers because they may become complacent with bad management if it serves the purpose of the rating agencies.[116] Put differently, ratings agencies may have mixed incentives. Rating agencies receive payment by the issuer of

114. KENNETH R. FERRIS & BARBARA S. PÈCHEROT PETITT, VALUATION: AVOIDING THE WINNER'S CURSE 74 (2002).

115. On the role of gatekeepers in the corporate context, see for example, Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323 (2007); Merrit B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089 (2008).

116. Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342 (2003).

the bonds that the agency rates.[117] Moreover, rating agencies create pressure on the issuers that they rate to purchase ancillary services such as pre-rating advice and consultations.[118]

There should be a risk premium associated with borrowing money for an SOE. Banks *should* lend at a higher rate of interest to SOEs since SOEs are more likely to be poorly managed relative to private firms. However, because the government either explicitly or tacitly guarantees this debt (which it does not do for most private firms), SOEs have an advantage over their private competitors. In November 2004, S&P put out a research paper that identified how they analyze debt of SOE postal providers. Ratings reflect the corporate governance of the SOE and the general supportiveness of the regulatory regime to the interests of the SOE.[119]

One critical element to S&P's analysis was to assess the level and intensity of state support of the firm. Where relations with the government are not seen as arms length and there is a debt guarantee, the credit quality of postal providers reflects the rating of the underlying government. If there is not such explicit support, S&P will examine whether there has been a history of providing financial support to other SOEs of that country. Ratings also reflect the possibility of privatization and the effect that privatization might have on state support. Perversely, the softer the budget, the *weaker* the punishment of a potential low rating because the *greater* the likelihood that the government will bail out the firm of its debt obligations. Such ratings reward inefficiency and create perverse incentives for SOEs.

4. Market for managers

An informal mechanism to reduce agency costs is the reputation of managers. Success or failure at a firm would, in theory, affect the ability of managers to negotiate their next contract and therefore future wages.[120] Therefore, reputational consequences may force a

117. Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 653–63 (1999).

118. Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. SUP. 341, 345 (2006).

119. Standard & Poor's, "International Postal Entities: Influence of Government Support on Ratings," Nov. 22, 2004.

120. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292 (1980).

manager to better run a firm to preserve his or her reputation going forward. Moreover, for managers at the end of their career, reputation still may be an important factor in leaving behind a "legacy" at a firm. This is not to suggest that some managers will be willing to risk long term reputation for short term gain. Corporate scandals such as Worldcom, Enron, and Tyco teach us otherwise.[121] Rather, in a number of cases reputation does serve to limit agency cost problems and the Enrons of the world are most likely outliers.[122]

In SOEs, managers may be poorly monitored relative to private firms. With SOEs, it is more difficult to measure reputation based on performance. Because of the lack of external controls such as access to the capital markets for equity and debt, it is more difficult to rate the performance of managers.[123] However, because the firm may not be profit maximizing, managers will be secure in their jobs regardless of firm performance. Many potential managers will choose careers in the private sector rather than the public sector because of greater pay, greater potential upside incentives for increased pay and in terms of risk taking and innovation. This is not to suggest that other excellent people do not choose government service within an SOE out of a sense of civic duty or altruistic motivations. Rather, for those managers in SOEs who are inferior to their counterparts in private firms, there is greater job security.[124] With market based accountability in private firms, it is easier to fire under-performing managers. At SOEs, it is more difficult to fire under-performers because standards are not clear or not important. Reputation matters little if you have lifetime employment, particularly because of how difficult it is to fire government workers relative to private works in

121. For a theoretical analysis of such scandals, see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 138 (observing that managers will risk reputation "if the immediate gains are large enough and if they cannot be required to disgorge their ill-gotten gains").

122. HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 37–42 (2006) (articulating the costly compliance costs of Sarbanes-Oxley).

123. Trebilcock & Iacobucci, *supra* note 61, at 1428.

124. Likewise, privatizing certain government work may create perverse incentives in terms of additional management duties for the most capable of government employees. *See* Mary Jane Angelo, *Harnessing the Power of Science in Environmental Law: Why We Should, Why We Don't, and How We Can*, 86 TEX. L. REV. 1527 (2008).

many countries. As such, there is less accountability for poor performance and less incentive to provide good performance.[125]

5. Bankruptcy

Forced exit through bankruptcy is a potential outcome for a poorly managed firm. Bankruptcy is one mechanism by which firms exit the market. It is the legal process through which the exit process unfolds for financially distressed firms. The risk of bankruptcy and possible liquidation forces many firms to undertake less risk because of the potential negative consequences of overly risky strategies. In contrast to private firms, SOEs generally do not go bankrupt (though countries sometimes do).[126] The lack of bankruptcy means that SOE managers do not face the same constraints as private firms for making mistakes. Without the potential specter of bankruptcy, SOEs might expand businesses even if there is not a profit making case to do so.

F. Transparency

Transparency is important both internally within the firm and externally to potential investors. The board of directors and shareholders need to understand the financial situation of a firm. Transparency is a necessary part of improved corporate governance. Usually, corporate governance reformers focus on independent boards. Yet, as Adams and Ferreira note, "unless boards are given better access to information, simply increasing board [outside] independence is not sufficient to improve governance."[127] Transparency plays a critical role because it allows the board to evaluate the business situation and provide effective management oversight. Increased transparency and effective corporate governance work hand-in-hand to monitor managers against shirking and stealing.[128] Cross country empirical work suggests that improved corporate transparency leads to greater efficiency across sectors.[129]

125. Where there are good performers at SOEs, these stars may get poached to the private sector, which provides greater financial rewards.

126. OECD, CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: A SURVEY OF OECD COUNTRIES 14 (2005).

127. Renée Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 235 (2007).

128. Richard A. Lambert, *Contracting Theory and Accounting*, 32 J. ACCT. & ECON. 3, 3 (2001) ("much of the motivation for focusing on objective and *verifiable* information and for

Externally, the market cannot accurately value a firm if there is insufficient transparency.[130] Transparency in private firms occurs through the reporting regime of securities law. A mandatory reporting regime reduces monitoring costs.[131] Private firms that trade in public securities markets utilize transparent reporting to better inform investors/owners about the potential quality of management. As Cross and Prentice summarize, "The [U.S.] federal securities laws are directed at the basic economic problem of investor risk by providing some legal guarantee of disclosure (reducing information asymmetry risk and transaction costs otherwise required for monitoring) and legal recourse for dishonest representations or omissions."[132] Nevertheless, a literature review on disclosure suggests that the effect of mandatory transparency remains unclear.[133]

Transparency exists not only at the level of securities disclosure overall, but at the level of audits that firms must undertake as part of compliance. With high levels of transparency (whether mandatory or voluntary), it is possible to audit a firm to determine if stated results are the same as actual results. Auditing provides a mechanism to review the books of the firm to ensure that stated performance

conservatism in financial reporting lies with incentive problems") (italics added); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455–56 (1997).

129. Jere R. Francis, Shawn Huang, Raynolde Pereira & Inder K. Khurana, *Does Corporate Transparency Contribute to Efficient Resource Allocation?*, J. ACCT. RES. (forthcoming 2009) (manuscript at 5, *available at* http://ssrn.com/abstract=1407065); Art Durnev, Vihang Errunza & Alexander Molchanov, *Predation and Investment Efficiency: Does Corporate Transparency Reduce Growth?* (McGill Working Paper Group), *available at* http://web.management.mcgill.ca/Art.Durnev/Corporate%20transparency.pdf.

130. Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1828–33 (2007); Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159, 162–66 (2007).

131. Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 363–64 (2006) (providing the background for disclosure); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1858–60 (2007) (discussing empirical "literature indicat[ing] that capital markets are improved by vigorous securities regulation featuring mandatory disclosure requirements, insider trading prohibitions, strong public enforcement, and provision of private remedies for defrauded investors") (citations omitted).

132. Cross & Prentice, *supra* note 131, at 364.

133. Christian Leuz & Peter D. Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research* (Mar. 2008), *available at* http://ssrn.com/abstract=1105398 ("Generally speaking, our survey finds a paucity of evidence on market wide and aggregate economic and social consequences of reporting and disclosure regulation, rather than the consequences of individual firms' accounting and disclosure choices.") (manuscript at 2).

matches actual performance.[134] This assumes, of course, that we trust auditors.[135] In the SOE context, this also assumes that we trust the auditing function of auditing firms over the auditing function of another part of government, which perhaps we might trust even less. Reputational concerns keep the monitoring function of audits higher than government audits because of concerns of managers or public perception of the role of the auditors. Poorly done audits will not lead to repeat business for the auditing firm in the private sector. With all the problems of private auditing firms, we still may prefer them to audits by other parts of government that may have even more reason to manipulate the results to look the "right" way.

Not all SOEs have strong transparency that allows for internal and external control or for an independent audit. Indeed, a common problem among SOEs is the lack of transparency. As a World Bank report states, "Internal and external financial and non-financial reporting is incomplete and inaccurate, does not provide an adequate basis for decision-making by boards and executive managers, and misleads government owners, legislatures and the public."[136] Because of a general lack of transparency of SOEs, it is oftentimes difficult to evaluate their costs relative to private firms.[137]

III. POSTAL ECONOMICS

Having addressed corporate governance of both government and private firms in the previous section, this section provides an overview of the postal sector, which serves as a case study of governance concerns of SOEs. The purpose of postal services is to deliver mail from one location to another. Because of the recent

134. Ronald A. Dye, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. POL. ECON. 887, 908 (1993) (explaining how auditing firms price their services); Srikant Datar & Michael Alles, *The Formation and Role of Reputation and Litigation in the Auditor-Manager Relationship*, 4 J. ACCT. AUDITING & FIN. 401, 401 (1995) (showing that "reputation formation by the auditor serves as a substitute for costly contracting, monitoring, and litigation by the owner"). *But see* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 302 (2004) (arguing that as gatekeepers, auditing firms were asleep at the wheel in some rather large and important corporate fiascos).

135. *See* Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game* (Bergen Meetings Working Paper, 2009), *available at* http://ssrn.com/abstract=1342986 (suggesting that we have reason to be suspicious of auditing firm reporting).

136. Scott, *supra* note 70, at 4.

137. OECD, DRAFT IMPLEMENTATION GUIDE TO ENSURE ACCOUNTABILITY AND TRANSPARENCY IN STATE OWNERSHIP 6 (2008).

communications revolution, this delivery system may be somewhat anachronistic. However, at present, letter mail remains an important part of the information infrastructure. The size of the postal sector immunized from direct competition (called the "reserve" sector because the monopoly is reserved for this sector) varies from country to country. The scope of the postal monopoly affects competition in the postal market. Additionally, a monopoly in the reserved sector may create additional distortions of competition. In some cases, revenues from the reserved sector may be used to anti-competitively cross subsidize those parts of business in which the post office must compete with other providers.[138] Firms that have a postal monopoly have immunity from competition in their core business. Corporate governance seems to be worse in such firms that lack competition, as theory would suggest, as the subsequent sections in this Article suggest. Postal SOEs compete in related services such as in express delivery services, banking, or insurance.

This section explains the importance of postal services. Then it explains why postal services have been treated as a regulated industry. Regulation has led to competition issues and various mechanisms in which government has distorted the competitive market to favor its postal SOEs. This section then provides an overview of corporate governance and antitrust of SOE postal firms in a number of jurisdictions before providing a more in depth study of both corporate governance and antitrust of the United States to provide contrasting approaches.

138. Cross subsidization was one of the chief concerns of the Department of Justice's Antitrust Division in the AT&T decision. United States v. W. Elec. Co., 894 F.2d 1387, 1391–92 (D.C. Cir. 1980). *Trinko* seems to suggest that proper regulatory oversight diminishes the need for antitrust to address such concerns. Verizon Commc'ns., Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004). The concern of potential cross subsidization and monopoly leverage also plays out in a European context. Cross subsidization between the postal reserve sector and the competitive sector constitutes state aid. Case C-39/94 *SFEI v. La Poste*, 1996 ECR I-3547. It may also allow for claims under abuse of dominance provisions. Case COMP/35.141, *Deutsche Post AG*, 2001 O.J. (L 125) 27. Some predation may be possible even with private firms that operate in network industries in which there is some additional layer of sector regulation. Sector regulation allows the government to assist in predation by private firms. Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG. 65 (1990) (addressing how government distortions created duplicative networks); James C. Miller III & Paul Pautler, *Predation: The Changing View in Economics and the Law*, 28 J.L. & ECON. 495, 500–02 (1985).

A. Importance of Postal and Express Services

Services have become an increasingly important part of the global economy. Services help facilitate increased specialization and scale across a number of fields, thus allowing for increased economic growth.[139] Postal and related services are among the services that underpin the functioning of the global economy. They facilitate the movement of goods and services both within a country and across countries. Recent theoretical work suggests that problems within a production chain can have a significant impact on output reduction if inputs enter the production chain in a complementary fashion.[140] For example, an increase in productivity in the transportation sector will raise the output in capital equipment. This in turn will raise output in the transportation sector.[141] Where there is a weak link, this has dynamic effects on economic development. Bad corporate governance and anti-competitive practices in the larger postal sector may be such a weak link to a country's economic development. Distortions in this sector may negatively impact the growth and development of alternative forms of information systems and communication. This is but one such network industry (banking, telecom, energy) that has country-wide implications.

Postal services are among the least competitive network industries in the world. Whereas other network industries, such as telecommunications and energy, have been liberalized and opened to various levels of competition, postal services remain heavily regulated statutory monopoly providers in most countries.[142] In nearly every country, the government has designated a postal monopoly for a portion of services that facilitate the movement of products from one

139. Joseph Francois, *Producer Services, Scale, and the Division of Labor*, 42 OXFORD ECON. PAPERS 715, 715 (1990); James Melvin, *Trade in Producer Services: A Heckscher-Ohlin Approach*, 97 J. POL. ECON. 1180 (1989); Wilfred Ethier & Henrik Horn, *Services in International Trade*, *in* THE INTERNATIONAL TRADE AND TRADE POLICY 223, 223 (Elhanan Helpman & Assaf Razin eds., 1991).

140. Charles I. Jones, *The Weak Link Theory of Economic Development*, 1 (Berkeley, Working Paper, 2007) (on file with author).

141. *Id.* at 5.

142. Damien Géradin & David Henry, *Regulatory and Competition Law Remedies in the Postal Sector*, *in* REMEDIES IN NETWORK INDUSTRIES, COMPETITION LAW AND SECTOR-SPECIFIC REGULATION (Damien Géradin ed., 2004); Charles Kenny, *Questioning the Monopoly-Supported Postal USO in Developing Countries*, *in* PROGRESS TOWARD LIBERALIZATION OF THE POSTAL AND DELIVERY SECTOR (Michael A. Crew & Paul R. Kleindorfer eds., 2006).

location to another (the "reserved" sector). In a number of cases, the postal sector has been immunized directly from antitrust suits. In other settings, the postal sector receives implied immunity from antitrust suits because of a preference of sector regulation over antitrust where sector regulators may not push competition as much as an antitrust agency might. There is an extensive literature of regulatory capture that explains why sector regulators may behave more favorably to the industries they govern.[143]

There are also non-antitrust competition policy distortions in the postal sector. The very nature of government ownership provides advantages such as lower cost of capital or exemptions from paying taxes.[144] Thus, SOE postal providers may not have the same capital costs as private ones because of these indirect government subsidies.[145]

B. Regulation of Postal Service

Generally, a sector regulator provides oversight over the regulatory aspects of postal services. In some countries, the same regulator may provide financial oversight as well as regulatory oversight. In other countries, financial oversight may be a function of a different government agency than regulatory oversight. A complicating factor in postal sector regulation is that sector regulators may need to make trade-offs between goals. Postal services have two potentially competing goals. One is a market correction function that serves the public interest. A country will regulate postal services to ensure service where otherwise there would not be coverage. Government does this through the use of universal service obligations (USOs). A second function of postal regulation is to provide services in a way that limits distortions on competition.[146] Because of potential conflicts between these two goals of postal

143. *See, e.g.*, JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION 475–514 (1993); DENNIS C. MUELLER, PUBLIC CHOICE III 523 (2003).

144. The USPS does not have to pay taxes but private firms do. J. GREGORY SIDAK & DANIEL F. SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY 2 (1996).

145. OECD, REGULATING MARKET ACTIVITIES BY PUBLIC SECTOR, DAF/COMP 36 (2004).

146. Damien Géradin & J. Gregory Sidak, *The Future of the U.S. Postal Service: American and European Perspectives After the Presidential Commission and* Flamingo Industries, 28 WORLD COMP. L. & ECON. REV. 163 (2005) (explaining competition policy and postal services).

regulation, situations may arise that may limit rather than create societal welfare. One potential effect of this interaction is to destroy the impetus to innovate and create new services that allow consumers to get goods from one place to another. Another is that the USO may be used to achieve anti-competitive ends. With competing interests, a sector regulator may not be as effective as an antitrust enforcer to improve efficiency. This is particularly true when the sector regulator also has the powers of competition enforcement.[147]

C. Potential Anti-Competitive Abuses in the Postal Industry

The postal sector traditionally has been vertically integrated. This leads to problems when government liberalizes only parts of the postal sector. When a government introduces competition to a vertically integrated industry, there are three potential types of anti-competitive abuses: discrimination, inflated transfer prices, and cross-subsidization.[148] Price discrimination is not in itself a concern of antitrust and occurs when a seller charges different prices to buyers for the same product or service.[149] Price discrimination can take on an anti-competitive effect if a postal service can limit access to its network or tie its regulated and unregulated services and thus create a loss to consumers.[150]

A postal monopolist also may use its monopoly in postal services to over-charge itself for inputs through transfer-pricing strategies. Transfer pricing refers to the pricing of various inputs within the same firm for goods and services. As a vertically integrated firm deals between affiliates, it can create a situation in which it prefers to deal with itself at inflated prices (which it captures through higher rates among its regulated customers) rather than deal with unaffiliated

147. This is not limited to the postal sector. These same concerns appear in many sectors. Italy and Brazil are good examples of this point in relation to banking and insurance. Darryl Biggar & Alberto Heimler, *An Increasing Role for Competition in the Regulation of Banks*, ICN 22 (2005).

148. Timothy J. Brennan, *Should the Flamingo Fly? Using Competition Law to Limit the Scope of Postal Monopolies*, 50 ANTITRUST BULL. 197, 202–04 (2005).

149. 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 721b, at 262 (2d ed. 2002).

150. For a recent example of this effect, see *Italian Authority Probes Activities of Post Office for Abuse of Dominance*, BNA ANTITRUST & TRADE REG. DAILY, Apr. 29, 2009.

providers.[151] This anti-competitive self-dealing allows companies to subsidize the upstream market or to create a price squeeze on downstream competitors.

Cross-subsidization occurs where a postal incumbent provider uses its network inputs in the regulated sector to compete in the unregulated sector. However, the postal incumbent allocates all or a disproportionate cost of the network to the regulated sector rather than the unregulated sector. When a sector regulator or antitrust enforcer does not detect this misallocation and remedy it, a postal monopolist can utilize an anti-competitive cross-subsidy.[152] Because of this misallocation of prices, cross-subsidization allows firms in the regulated sector that have a monopoly to exclude in the unregulated sector. They do so in part by preventing an efficient entrant from achieving economies of scope, which the incumbent has in the regulated sector because of its designated monopoly.[153]

In some cases, the regulated monopolists may have the means to price below marginal cost for a sustained period of time and engage in predation.[154] This is particularly possible in the case of postal SOEs.[155] Similarly, postal SOEs may be more likely to be able to raise the cost of rivals because of the SOEs' incentive to be a revenue maximizer and increase its output and scale. They also may be able to effectively shape government regulation to raise rivals' costs directly by creating an expansive reserve sector. Such behavior limits the potential economies of scope and scale of potential rivals.[156] Part V will elaborate on these issues.

These three types of problems have two types of effects on postal and related markets. Directly, they impact the ability of companies to enter and compete in a given country through the erection of high

151. Alexander C. Larson & Steve G. Parsons, *An Economic Analysis of Transfer Pricing and Imputation Policies for Public Utilities*, *in* INCENTIVE REGULATION FOR PUBLIC UTILITIES (Michael A. Crew ed., 1994).

152. OECD, INTERNATIONAL PARCEL DELIVERY, OCDE/GD (97)151, 97 (1997).

153. David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 511–12 (2003).

154. Case COMP/35.141, *Deutsche Post AG*, 2001 O.J. (L 125) 27.

155. On SOE predation, see generally David E.M. Sappington & J. Gregory Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 22 REV. INDUS. ORG. 183, 199 (2003).

156. *Id.* at 197–98; *see* J. GREGORY SIDAK & DANIEL F. SPULBER, PROTECTING COMPETITION FROM THE POSTAL MONOPOLY 18–31 (1996) (discussing the Postal Service's statutory monopoly over letter delivery).

entry barriers. Anti-competitive behavior also directly impacts companies that compete internationally because of the ability of SOEs to use cross-subsidies to expand internationally. This allows for the export of anti-competitive conduct into other jurisdictions. Domestic antitrust institutions in the foreign markets are ill equipped to address anti-competitive conduct by foreign postal services because of a lack of an effective supra-national regulatory regime (except in the case of the EU). Indirectly, there is an even greater harm. Market failure due to government intervention that allows for anti-competitive conduct affects exporters from both developing and developed countries from using a critical part of delivery infrastructure to provide fast shipment of goods and services.

There is a secondary effect of a concentrated postal market due to government preferences that favor incumbent postal SOEs. A focus on postal national champions may stymie domestic innovation from small and medium sized entities (SMEs) both in postal services and in the economy overall. In OECD countries, over 95% of all firms are SMEs. Of OECD SMEs, 30–60% can be categorized as innovative firms.[157] A similar percentage of firms within the developing world are SMEs.[158] If one believes that SMEs are a growth engine for the economy, one should be concerned that the dynamic effects of SMEs may be limited because of the inability of private firms to offer new services and product and service innovations to these SMEs.[159] Whereas large firms may function well in either a good or bad institutional setting, SMEs require high quality institutions to allow for competitive entry into markets.[160]

D. Problem of Universal Service Obligations

An often-made argument by postal incumbents is that the postal provision requires antitrust immunities, such as a statutory monopoly to serve the USO. Under the USO, the postal service provides all

157. OECD, *Small and Medium-sized Enterprises: Local Strength, Global Reach*, OECD OBSERVER, June 2000, at 1.

158. Marta Kozak, *World Bank Small and Medium Enterprise Database*, INT'L FIN. CORP. (IFC) (last updated Jan. 26, 2007), http://rru.worldbank.org/ Documents/other/ MSMEdatabase/msme_database.htm.

159. Though there is no empirical evidence for this proposition, this is a function of data limitations.

160. *See generally* Thorsten Beck et al., *Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?*, 60 J. FIN. 137 (2005) (concluding that the smallest firms are the most negatively impacted when financial and institutional development is weak).

consumers with mail service, even those for whom it is not profitable to provide such a service, such as in rural areas.[161] Incumbent postal providers argue that liberalization of postal services would allow for potential cream skimming of the most profitable customers. Postal incumbents, however, would need to continue to serve unprofitable routes as part of a USO. This situation would leave an incumbent provider with a graveyard spiral of higher costs and forced rate increases as all but the unprofitable customers leave the incumbent. Such an outcome would result in the end of the cross-subsidy that allows for universal service.

In a number of cases, these concerns are unfounded.[162] For example, empirical evidence suggests that there is no urban-to-rural cross-subsidy by the U.S. Postal Service.[163] Therefore, in a world of liberalization or privatization, rural service would continue to exist.[164] This reduces the argument for a monopoly based on the need to preserve a USO. The USO argument does not hold for most jurisdictions around the world. Experience in other countries illustrates that a USO cross-subsidy can be replaced altogether with targeted subsidies for low income and other groups.[165] In other

161. In the developing world, a USO may make even less sense because of the cost of the postal monopoly model and its effect on sector development. Many consumers in developing countries use postal services infrequently, if at all, and a developing world USO will rarely be used to help the poor. This makes a USO not sustainable given the lack of scale economies. *See generally* Charles Kenny, *Questioning the Monopoly-Supported Postal USO in Developing Countries*, *in* PROGRESS TOWARD LIBERALIZATION OF THE POSTAL AND DELIVERY SECTOR 75 (Michael A. Crew & Paul R. Kleindorfer eds., 2006) [hereinafter PROGRESS (Crew & Kleindorfer)] (arguing for a "competitive approach involving universal access" for services the poor need).

162. USOs are used in a number of liberalized regulatory markets, like telecom.

163. Robert H. Cohen et al., *The Cost of Universal Service in the U.S. and its Impact on Competition*, *in* The Proceedings of Wissenschaftliches Institut fur Kommunikationsdienste GmbH (WIK) 7th Köenigswinter Seminar on "Contestability and Barriers to Entry in Postal Markets" 5 (Draft 2003), 1–2; RICK GEDDES, SAVING THE MAIL: HOW TO SOLVE THE PROBLEMS OF THE U.S. POSTAL SERVICE 3 (2003).

164. *See* Robert H. Cohen et al., *Rural Delivery and the Universal Service Obligation: A Quantitative Investigation*, *in* REGULATION AND THE NATURE OF POSTAL AND DELIVERY SERVICES 170–71 (Michael A. Crew & Paul R. Kleindorfer eds., 1993). Similarly, theoretical work suggests that there would be no such graveyard spiral in the United States if it were to remove the USPS monopoly of letter delivery. *See* Robert Cohen et al., *An Empirical Analysis of the Graveyard Spiral*, *in* COMPETITIVE TRANSFORMATION OF THE POSTAL AND DELIVERY SECTOR 121–22 (Michael A. Crew & Paul R. Kleindorfer eds., 2004). *See generally* Michael A. Crew & Paul R. Kleindorfer, *The Welfare Effects of Entry and Strategies for Maintaining the USO in the Postal Sector*, *in* PROGRESS (Crew & Kleindorfer), *supra* note 161, at 359 (projecting the potential of small welfare gains in the U.S. with the elimination of the USO).

165. WORLD BANK, WORLD DEVELOPMENT REPORT 164–66 (2002).

markets where postal markets have been liberalized, these countries have not abandoned the USO.[166]

An uncompetitive postal sector may create incentives for politicians to create a large USO fee. One danger of a USO is that the fee will be set too high. An overly high USO allows the possibility that a postal provider can use funds from an overly generous USO to cross-subsidize into the non-reserve market.[167] The non-reserve or competitive sector includes related services, such as express delivery services, where postal providers compete with international express services firms, such as FedEx and UPS. Thus, anti-competitive conduct of postal services focuses primarily in express delivery services, although it also affects hybrid mail services and other services offered by postal incumbents, such as banking and insurance. The smaller the reserve sector is in a particular country, the less likely anti-competitive conduct will spill over into related products and services.

E. Scope and Problem of SOEs in the Postal Sector

State ownership may reflect a particular problem in postal and related services.[168] Unlike other network industries, for the most part postal services remain in state hands.[169] There are unique challenges to this sector because of the nature of state ownership and state facilitated restraints on competition. SOEs may be more, rather than less, likely to make a market less competitive because of their ability

166. *See generally* Anna Lundgren, *Sustainability of USO in a Liberalized Postal Market*, *in* POSTAL AND DELIVERY SERVICES: PRICING, PRODUCTIVITY, REGULATION AND STRATEGY 75, 84 (Michael A. Crew & Paul R. Kleindorfer eds., 2001) (finding that the USO has proven to be sustainable in Sweden); Per Jonsson & Sten Selander, *The "Real" Graveyard Spiral: Experiences from the Liberalized Swedish Postal Market*, *in* PROGRESS TOWARD LIBERALIZATION OF THE POSTAL AND DELIVERY SECTOR 359, 359 (Michael A. Crew & Paul R. Kleindorfer eds., 2006) (observing that Sweden's liberalized postal service has not led to a "graveyard spiral" as predicted by Crew and Kleindorfer).

167. The calculation of break-even costs for the USO is difficult. *See generally, e.g.*, Philippe Choné, Laurent Flochel & Anne Perrot, *Allocating and Funding Universal Service Obligations in a Competitive Market*, 20 INT'L J. INDUS. ORG. 1247 (2000); John C. Panzar, *Funding Universal Service Obligations: The Costs of Liberalization*, *in* FUTURE DIRECTIONS IN POSTAL REFORM 101, 101 (Michael A. Crew & Paul R. Kleindorfer eds., 2001) (arguing that any analysis of the cost of a USO must first give careful consideration to an "unsubsidized market scenario").

168. OECD, PROMOTING COMPETITION IN POSTAL SERVICES, DAFFE/CLP(99)22 (1999).

169. D. Daniel Sokol, *Express Delivery and the Postal Sector in the Context of Public Sector Anti-Competitive Practices*, 23 NW. J. INT'L L. & BUS. 353, 370 (2003).

to use government to erect competitive restraints to the benefit of the SOE. This theoretical claim has support from a number of empirical studies.[170] Similarly, the government as regulator may provide preferences to its own SOEs as market participants.[171]

Furthermore, where the state is both a market participant and regulator, there is little incentive for a postal incumbent to adopt new technologies. Indeed, the postal incumbent may try to block innovations if they were to facilitate new entry.[172] In the U.S. context, the USPS attempted to expand its reach to electronic services in the early 1980s in order to regulate the precursor to the internet. The USPS took steps that could have resulted in e-mail falling within the postal reserve monopoly.[173] Only FTC competition advocacy prevented such an outcome.[174] If left to itself, a postal incumbent will attempt to increase the scope of its reserved area and its mandate, and engage in cross-subsidization in express delivery services.[175]

IV. CORPORATE GOVERNANCE OF POSTAL SOES

This Part provides a descriptive cross-country analysis of SOE corporate governance of postal SOEs. It highlights the main features of SOE laws and of postal-specific laws in the countries studied. The purpose of this series of case studies is to illustrate the various permutations that laws take in addressing SOE corporate

170. Sappington & Sidak, *supra* note 155, at 199; R. Richard Geddes, *Pricing by State-Owned Enterprises: The Case of Postal Services*, 29 MANAGERIAL & DECISION ECON. 575, 587 (2008) (theorizing that SOEs will raise prices in inelastic markets if profits are weighted positively).

171. *See generally* Geoff Edwards & Leonard Waverman, *The Effects of Public Ownership and Regulatory Independence on Regulatory Outcomes*, 29 J. REG. ECON. 23, 51 (2006) (finding that governments influence regulatory outcomes in favor of SOEs).

172. Edward M. Graham, *Approaches to Competition Policy*, *in* TRADE RULES IN THE MAKING: CHALLENGES IN REGIONAL AND MULTILATERAL NEGOTIATIONS 423 (Miguel Rodriguez Mendoza et al. eds., 1999). SOEs also have an incentive to utilize inefficient technology to realize incremental costs lower than competitors in the unregulated market. The greater the technological inefficiency, the greater the revenue maximization from expanded output. Sappington & Sidak, *supra* note 155, at 195; *see also* Timothy Brennan, *Entry and Welfare Loss in Regulated Industries*, *in* COMPETITION AND THE REGULATION OF UTILITIES 147 (Michael Crew ed., 1990) (arguing that SOEs may use wasteful spending on R&D as a deterrent to new entrants).

173. JOHN C. HILKE, IMPROVING RELATIONSHIPS BETWEEN COMPETITION POLICY AND SECTORAL REGULATION ¶ 46 (2006).

174. *Id.*

175. GEDDES, *supra* note 163, at 1.

governance. This Part does not examine the very sparse case law underlying these laws. Rather, it analyzes the laws on the books to understand how the laws address the theoretical distinctions between public and private ownership.[176] Legal origins do not explain the corporate governance of SOEs.

All countries have transparency provisions and board-level governance provisions. On paper it would seem, therefore, that all SOEs should have good governance mechanisms. However, the amount of transparency varies across countries (not all provide the same level of transparency as those firms that are publicly traded on the local stock market). Moreover, not all governance is the same. In some SOE laws there is a provision for profit maximization and board selection reflects this goal. In other countries, board selection rewards political favorites, rather than those with management experience. In some countries, such as Korea, the postal SOE is directly a part of government and has not been corporatized.

A. Chile

The Sistema de Empresas Publicas (SEP) that oversees Correos Chile sets up a model of corporative governance to attempt efficient and transparent oversight. SEP requires Chilean SOEs to make information regarding its management publicly available. To do so, Chilean SOEs must submit their financial records to external audits. To reduce the possibility of self-dealing, the SEP prohibits board members from undertaking business decisions that would affect a board member's personal interests.[177] It also places limitations on the method of financing for the SEP companies.[178] The SEP does not contain discussion of an efficiency rationale nor does it address issues of soft budget constraints.

Unless otherwise specifically provided in company by-laws the Ley de Sociedades Anónimas (Corporations Act) applies only to such SEP-managed companies organized as "sociedades anónimas" (e.g., Metro S.A., Zofri S.A., Essbio S.A., Aguas Andinas S.A., etc.). Many SEP-managed companies were created by law or by a decree with force of law (*decreto con fuerza de ley*) and as such, they have a special

176. A study of the law as practiced would be helpful but is not possible given the paucity of cases.

177. SEP art. 8.

178. *Id.* at art. 12.

legal status. This law does not apply to Correos Chile. Article 1 of DFL 10/1982 that created Empresa de Correos de Chile provides:

> Créase una persona jurídica de derecho público que se denominará "Empresa de Correos de Chile." La Empresa de Correos de Chile será un organismo de administración autónoma del Estado, con patrimonio propio, que estará sujeta a la fiscalización de la Contraloría General de la República. Se regirá por las disposiciones del presente decreto con fuerza de ley y sus reglamentos y, en lo no previsto en ellos, por la legislación común.[179]

Considering the last sentence, some may argue that the Corporations Act would apply to Correos. However a more accurate reading of "legislación común" would be to make reference to the Civil Code and other laws of general applicability.

Directors of Chilean SOEs must follow rules based on substance and procedure of the Law of Joint-Stock Companies and Law of Administrative Probity. Under these laws, directors have a duty of conduct, loyalty, and honesty. The Law of Administrative Integrity establishes the mechanisms for disqualifying a company's directors, as well as requires directors to provide disclosure of potential conflicts of interest.[180]

The Chilean Postal Law provides additional guidance concerning corporate governance.[181] The law includes provisions on the role of the board of directors and restrictions to prevent self dealing. This includes barring members of political parties and unions that have related interests with Correos from board positions.[182] There is no discussion in the law of how to prevent cross-subsidization from the monopoly business to competitive related businesses.

179. Unofficial translation: A legal person of public right is created that will denominate "Company of the Post Office of Chile." The Company of the Post Office of Chile will be an organ of independent administration of the State, with its own patrimony, that will be subject to the control of the General Contraloría of the Republic. It will be in force by the dispositions of the present decree with force of law and its regulations and, those not anticipated in them, by the common legislation.

180. Ley 19.653 – Probidad Administrativa (Law of Administrative Probity (Integrity)): Article 1 (7) specifies the justifications for transparency in administrative procedures. Similarly, Ley 19.880 – Procedimiento Administrativo (Law of Administrative Process), discusses how administrative procedures are to be carried out, including the principles that guide administrative actions (transparency, expediency, and efficiency) and the rights of the public.

181. DFL 10, 30–01–1982 as amended by DFL 22, 02–09–2003, *available at* https://www.correos.cl/empresa/documentos.php.

182. *Id*. at art. 8.

B. New Zealand

The State-Owned Enterprises Act[183] ("SOEA") governs SOEs (called "Crown Companies") in New Zealand. Under Section 4 of the Act, the principal objective of an SOE is to be as profitable as comparable businesses that are not state owned. This calls into question the need for SOEs in the first place. The answer to this Section is that the SOE legislation was created as part of a staged privatization.[184] It was seen as a nod to public opposition to have a special statute, rather than to utilize the Companies Act.[185] Including express language of "good employer" and "social responsibility" in Section 4 added just enough differentiation from firms governed by the Companies Act to be politically palatable. While these are barely justiciable objects, they are greater than the requirements of the Companies Act; being a good employer and acting with social responsibility are not express objects of ordinary companies. While there is nothing in the Companies Act to prevent directors from acting as good employers and with social responsibility, there are no affirmative duties as such to do that. Collectively, the New Zealand SOE regulatory system creates a system with requirements as close to that of private firms as possible. To the extent that governance affects performance, it should be the case that the performance of New Zealand Post should be among the best performing postal SOEs.

The SOEA provides a number of transparency provisions. SOEA Section 14 provides that SOEs must deliver a statement of corporate intent to shareholders,[186] whereas SOEA Section 15 mandates that SOE deliver annual reports, statements of accounts, and dividends.[187] Under SOEA Section 18, shareholders can make requests of other information.[188] Sector regulation also mandates transparency.

Crown Company board duties in New Zealand enumerate the expectation of ownership by the state including the ability to monitor senior management (e.g., the CEO), undertake compliance

183. *Available at* http://www.legislation.govt.nz/act/public/1986/0124/latest/DLM97377.html.

184. Graham Scott, After the Reforms: Some Questions about the State of the State in New Zealand, 4 PUB. Q., June 2008, at 3, 6.

185. Companies Act 1993, 1993 Public Act No. 105 (N.Z.).

186. State-Owned Enterprises Act 1986, 1986 Public Act No. 124 § 14(1) (as at 01 Apr. 2008) (N.Z.).

187. *Id.* § 15.

188. *Id.* § 18.

with statutes, increase shareholder value, and create appropriate governance structures.[189] New Zealand SOEs must also provide Statements of Corporate Intent ("SCI"). New Zealand Post provides a three year set of plans as part of this SCI. For example, in the SCI that covers 2007-2010, New Zealand Post announced that it will seek to keep its postal business profitable, grow its Kiwibank subsidiary, and increase the profitability of its express services business.[190] The SCI provides statistical performance targets for New Zealand Post for the three years. A special Crown Companies Monitoring Advisory Unit monitors the corporate governance and performance of SOEs.[191]

Board-level governance under the SOEA provides that as representatives of the government, ministers can hold shares in an SOE.[192] This grants Ministers the power to request information. The SOEA provides for management oversight by the board through directorships. The SOEA defines the role of the director as a person who will help SOEs achieve their principal objectives.[193] There is some specificity as to what these goals are. Moreover, the SOEA creates an arms-length relationship in terms of oversight between government and NZP by distancing management tasks from political control.

A sector-specific regulatory framework also applies to New Zealand Post. The Postal Services Act of New Zealand ("PSA NZ") removed the New Zealand Post's delivery monopoly on standard letters.[194] This sector liberalization has increased competition and it may be that the corporatized structure of New Zealand Post is a reflection of the need for better governance due to the threat of greater competition. So long as a company is registered with the

189. CROWN COMPANY MONITORING ADVISORY UNIT, OWNER'S EXPECTATION MANUAL FOR STATE-OWNED ENTERPRISES § 8 (2007).

190. NEW ZEALAND POST LIMITED, STATEMENT OF CORPORATE INTENT 1 (2007), *available at* https://www.nzpost.co.nz/NZPost/Images/NZPost/PDF/2007StatementOfCorporateIntent.pdf.

191. The specific functions of this unit include: ownership environment management, performance monitoring, issue management, and governance. *See generally* CROWN COMPANY MONITORING ADVISORY UNIT, STATEMENT OF INTENT (2008), *available at* http://www.treasury.govt.nz/publications/abouttreasury/soi/2008-13/09.htm.

192. State-Owned Enterprises Act 1986, 1986 Public Act No. 124 § 10 (as at 01 Apr. 2008) (N.Z.).

193. *Id.* § 5.

194. *See* Postal Services Act 1998, Public Act 1998 No. 2 § 29 (N.Z.), *available at* http://www.legislation.govt.nz/act/public/1998/0002/latest/DLM423258.html.

Ministry of Economic Development, it can deliver mail. PSA NZ allows for the Governor-General to create regulations to require a postal operator to provide information on accounting and compliance.[195] Specifically, PSA NZ requires that postal providers disclose information that relates to service, such as price, frequency of service, quantity of service, and quality of service. For example, PSA Section 55 requires that regulated firms submit information, reports, etc., to the regulator to monitor the efficiency and quality of postal services that firms provide.[196] The Act also requires disclosure of financial statements including profit and loss statements and balance sheets.[197]

C. United Kingdom

The Postal Services Act of 2000 ("PSA UK") established the Postal Services Commission (Postcomm).[198] The Act requires universal postal service at a uniform price throughout the UK and promotes competition among providers. Postcomm regulates Royal Mail (the SOE) through a number of different mechanisms. Postcomm sets quality of service standards and imposes financial penalties for failing to meet those standards. Postcomm sets the framework for Royal Mail's prices (with an aim to reach efficiency in service standards and to reduce barriers to entry for other market participants) and intervenes in situations in which Royal Mail does not offer access to its network.

As part of transparency, the Act requires that postal firms send copies of annual audited accounts to the Secretary of State.[199] PSA UK also requires that postal companies make information available upon request to the Treasury regarding public sector finance issues.[200] It also mandates that the Commission exercise oversight functions to promote more effective competition.[201] To protect against anti-competitive conduct by postal providers, Postcomm has

195. *Id.* § 60.

196. *Id.* § 55.

197. *Id.* § 60.

198. Postal Services Act, 2000, c. 26, Part 1, § 1 (Eng.), *available at* http://www.opsi.gov.uk/acts/acts2000/ukpga_20000026_en_1.htm.

199. *Id.* § 77.

200. *Id.* § 78.

201. *Id.* § 5.

investigation powers to oversee conduct.[202] Along with investigatory powers, Postcomm has the ability to impose financial penalties for violations of license conditions.[203] PSA UK assigns such penalties based on a reasonableness standard, with a maximum penalty of 10 percent of the turnover of the postal license holder.[204] Because of concurrent regulation, the Competition Commission can overrule any Postcomm decision that the Competition Commission believes to be anti-competitive.[205] Royal Mail provides an annual report including financial details of performance and information about its senior leadership.[206]

Royal Mail is a public limited company (PLC), which means that the Companies Act governs Royal Mail. The Companies Act imposes certain obligations upon directors. They include the submission of a director's remuneration report, a duty of loyalty to the company, a duty to exercise independent judgment, board authorization, and ratification.[207] Listing rules create specific procedural requirements to ensure transparency and information flow from listed companies.[208] Because of the involvement of a number of different regulators (Treasury, Postcomm, Competition Commission) there are fewer opportunities for all regulators to be captured by Royal Mail, as might be the case with a single regulator that oversees all financial and regulatory functions.[209] The various UK governance mechanisms make SOEs, including Royal Post, accountable in ways similar to private firms. The quality of governance should be good relative to other countries' postal SOEs, particularly given increased liberalization within the postal sector.

European postal regulation adds another regulatory dimension to accountability and transparency of postal providers in the UK and other EU Member States. Under the European Community Postal Directive, tariffs applied to the universal service are to be "objective,

202. *Id.* § 57.

203. *Id.* § 30–36.

204. *Id.* § 30.

205. *See* http://www.competition-commission.org.uk/our_role/what_investigate/index.htm.

206. The Shareholder Executive Annual Report 2007–08, *available at* http://www.shareholderexecutive.gov.uk/publications/pdf/annualreport0708.pdf.

207. Companies Act, 2006, c. 46, §§ 170–77 (Eng.).

208. *See, e.g.*, United Kingdom Listing Authority Listing Rules § 7.2.1R (Jan. 2005).

209. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (explaining capture).

transparent, non-discriminatory and geared to costs."[210] Any postal provider with universal service obligation needs to create an independently verifiable cost accounting system.[211] This system must provide transparency in accuracy of cost allocation.[212] Further EU Postal directives articulate with more specificity the nature of transparency and costs:

> [P]roportionality . . . should continue to be applied to any financing mechanism and any decision in this area should be based on transparent, objective and verifiable criteria. In particular, the net cost of the universal service should be calculated, under the supervision of the national regulatory authority, as the difference between the net costs of a designated universal service provider operating under a universal service obligation and not operating under a universal service obligation. The calculation should take into account all other relevant elements, including any market benefits which accrue to a postal service provider designated to provide universal service, the entitlement to a reasonable profit and incentives for cost efficiency.[213]

In addition to transparency and proportionality, the EC Postal Directive increases the scope for potential competition by opening competition within the postal sector.[214] This includes a narrowing of the weight limit of postal services that can be reserved as part of the postal monopoly, as well as price limits.[215]

D. Sweden

The Swedish Code of Corporate Governance ("SCCG") is a non-binding set of recommendations to improve corporate governance for stock market companies and some SOEs, including the postal provider Posten.[216] The SCCG suggests that corporate board provide annual financial reports, stock exchange reports,

210. Directive 97/67/EC, 1998 O.J. (L 15) 26.

211. *Id*. at 29.

212. *Id*.

213. Directive 2008/6/EC, 2008 O.J. (L 52) 29 (amending Directive 97/67/EC 1998 O.J. (L 52) 7).

214. Directive 2002/39/EC, 2002 O.J. (L 176) 21.

215. *Id*. at 16–18.

216. Swedish Code of Corporate Governance (A Proposal by the Code Group), art. I, § 1.2 (Apr. 21, 2004), *available at* http://www.sweden.gov.se/sb/d/4089/a/26296.

reports on corporate governance and internal controls.[217] The SCCG also suggests mechanisms for internal control.[218]

Article III, Sections 3.5.1–.6 of the SCCG address board procedures. These sections require that firms must provide annual, clear, formal work plans and include standard procedures such as the establishment of special committees, and evaluations of the performance of managers.[219] The Division for State Enterprises of the Ministry of Enterprise, Energy and Communications applies uniform structures for SOE board nomination processes.[220] This includes an analysis of the SOE's current board composition and the identified needs that new board members should fill.[221] Because actual needs drive the board nomination process, the quality of board members seems to be better than those of SOE board members in other countries (at least in postal), merely based on biographical sketches provided of board members of other countries studied for this Article. The postal regulator is the Swedish Post and Telecom Agency. It ensures that postal operators such as Posten meet their license conditions. Since 1994, Posten is structured as a 100 percent state-owned limited liability company.[222]

In Sweden, "'Board members have the same unlimited responsibility as board members of privately-owned companies.'"[223] Swedish SOEs hold annual meetings, which are open to the general public.[224] Like other Swedish companies, SOEs must submit an annual report regarding the board's work in the previous year.[225] Transparency is not merely an issue of corporate governance, but of transparency of government more generally: "For state-owned companies, the requirement for an open and professional provision

217. *Id*. at art. III, §§ 3.5–8.

218. *Id*. at art. III, § 3.7.

219. *Id*. at art. III, §§ 3.5.1–6.

220. Maria Vagliasindi, *The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries*, 9 (World Bank Policy Research, Working Paper No. 4579, 2008).

221. *Id*.

222. In Sweden, the regulatory situation becomes more difficult when Posten mergers with Post Denmark, in which both governments will hold joint ownership and, presumably, joint regulatory oversight.

223. OECD, CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES: A SURVEY OF OECD COUNTRIES 138 (2005) (quoting Aktiebolagslag [ABL] [Swedish Company Act] 1975:1385 (Swed.)).

224. *Id*. at 102.

225. *Id*. at 100.

of information transparency is a question of democracy since the companies are ultimately owned by the Swedish people."[226] For this reason, the government of Sweden has, since 1999, published an annual report for SOEs.[227] The Annual Report of State-Owned Companies reveals publicly the balance sheet, income statement, cash flow and other financial information of Posten.[228] The Report also announces a profitability target ("10 percent of net profit in relation to average shareholder's equity").[229] If SOEs have a governance structure and set of duties and reporting requirements similar to private firms, one must ask why have them state-owned at all, at least in those industries that can be competitive. As with New Zealand, corporate governance that is very similar to private firms suggests that Swedish SOEs and Swedish Post as a case study should have among the best governance and performance outcomes of postal SOEs.

E. South Africa

In South Africa, SOEs are subject to the same legislation as privately owned companies, such as the Companies Act.[230] Under Section 33 of the Companies Act, companies must file an annual transparency and accountability report.[231] This entails submitting yearly financial statements.[232] The current Companies Act is general legislation regulating companies but does not distinguish between state-owned and other companies.[233] The new Companies Bill of 2008 does make the distinction between state-owned and other companies but no distinction is made in the context of corporate-governance rules.[234] For example, the Bill codifies fiduciary duties—duty of loyalty and duty of care.[235] These duties, however, apply to

226. *Id*. at 98 (quoting *Annual Report State-Owned Companies 2003*, (Regeringskansliet, Sweden), June 2004 at 17).

227. *Annual Report State-Owned Companies 2007*, (Regeringskansliet, Sweden), Oct. 2008, at 11.

228. *See id*. at 66.

229. *Id*. at 68.

230. Companies Act 61 of 1973.

231. *Id*. at § 33.

232. *Id*.

233. *See id*. §§ 2, 19.

234. *Compare* Companies Bill, 2008, Bill 61-2008 (GG), § 9, *with* part F.

235. *Id*. § 76.

all companies.[236] In practice, the duties might not always be the same.

The Postal Services Act[237] provides that there must be fair competition within the postal industry. South Africa Post may have a business rationale other than profit. Supporting the lack of profit rationale for South Africa Post is explicit language in the Postal Act that grants a possible yearly subsidy for South Africa Post.[238] According to the Postal Industry Code of Practice, postal operators cannot engage in unfair pricing.[239] However, this does not seem to refer to predatory pricing. Rather it refers to price discrimination. The postal regulator must regulate to provide "equal access for all citizens."[240] Among the other mandates under the Postal Act is to promote stability.[241] Such functions make it more difficult for postal operators to pursue a profit strategy.[242] Indeed, the law explicitly provides for annual subsidies to postal providers.[243] Though the subsidies must be on specific terms, there is no policing function enumerated in the law to prevent a postal company from anti-competitive cross-subsidization.

In terms of transparency, the King II Report on Corporate Governance mandates formal and transparent procedures for board of director nominations.[244] Other parts of the Report focus on such corporate governance issues as reporting, accounting and auditing, and compliance and enforcement. South Africa Post uses an independent auditor for a review of its financials.[245]

Overall corporate governance provisions for SOEs and for South Africa Post are weaker than in other countries that have standards akin to those of private firms. For political reasons, South Africa has

236. *Id.*

237. Postal Services Act 124 of 1998.

238. *Id.* § 29.

239. POST OFFICE, CODE OF PRACTICE (FOR SOUTH AFRICAN POSTAL INDUSTRY), *available at* http://www.sapo.co.za/Documents/Code%20of%20Practice%20FINAL.pdf.

240. Postal Services Act, § 8.

241. *Id.* § 2(k).

242. *See id.* § 8(1)(f).

243. *Id.* § 29(1).

244. KING COMMITTEE ON CORPORATE GOVERNANCE, EXECUTIVE SUMMARY OF THE KING REPORT 2002, 23 ¶ 2.2.2, *available at* http://www.nfcgindia.org/kingcommittee2002.htm.

245. Most recently, the external auditor was KMPG. *See* POST OFFICE, SOUTH AFRICAN POST OFFICE ANNUAL REPORT 2007, 34–35, *available at* http://www.sapo.co.za/AboutUs/Post%20Office%20AR%20ACC_36432.pdf.

chosen to maintain a soft budget constraint, and this should affect the overall governance of SOEs.

F. Canada

The Canada Post Corporation Act transformed the Canadian Post Office Department into a government owned corporation (Crown Corporation) in 1981.[246] Sections 151 and 152 of the Financial Administration Act of 1984 mandate an annual report to parliament on the status of Crown Corporations.[247] This report provides a brief summary of each of the Canadian SOEs, including Canada Post.[248] Auditing of Canada Post occurs both from a government auditor (Auditor General of Canada) and an outside auditor (KPMG).[249] Canada Post produces an annual report that includes consolidated financial statements.[250] Nevertheless, government reports suggest that there are problems in the corporate governance of Canadian SOEs.[251]

To ensure the quality of oversight and decision-making of the board, the board of Canada Post undertakes regular self-assessment surveys. There is a specific corporate governance committee for the board. Criteria for joining the board suggest that members hold certain skills. A review of the current board shows that board members have a number of different backgrounds that potentially could bring value to the board. Moreover, the board process is a continuous one in that there are opportunities for board members to receive additional training opportunities to improve the skills of board members.[252]

The Canada Post Corporation Act specifies goals about service but does not establish an efficiency goal.[253] However, Canada Post is required to earn a "reasonable" rate of return on equity in a

246. Canada Post Corporation Act, R.S.C., ch. C 10, §§ 1–34 (1985).

247. Financial Administration Act, R.S.C., ch. F 10, §§ 151–52 (1984).

248. *See, e.g.*, TREASURY BOARD OF CANADA SECRETARIAT, CROWN CORPORATIONS AND OTHER CORPORATE INTERESTS OF CANADA 2007, § 2.4, *available at* http://www.tbs-sct.gc.ca/reports-rapports/cc-se/2007/cc-setb-eng.asp.

249. *Id*.

250. *See, e.g.*, Canada Post, 2007 Annual Report 86–122, *available at* http://www.canadapost.ca/corporate/about/annual_report/pdf/en/Full_ARs/AR_2007_Eng.pdf.

251. *See* OFFICE OF THE AUDITOR GENERAL OF CANADA, 2000 DEC. REPORT ch. 18, *cited in* OECD, *supra* note 223, at 97.

252. *Id*.

253. *See* Canada Post Corporation Act, R.S.C., ch. C 10, § 5 (1985).

"commercial" environment, which suggests a profit motive of some sort.[254] The Act provides typical rules about who can serve as members of the board of directors and the length of time of service.[255] Nevertheless, there are no provisions that explicitly address the potential for anti-competitive cross subsidization.[256] Academic work suggests that Canada Post remains relatively inefficient. Competitors complain, for example, of various government-created barriers to entry.[257]

Canada Post is a case of a firm that is corporatized but not to the extent of SOEs in Sweden or New Zealand. Because of its monopoly position and state ownership, it takes advantage of a soft budget constraint.[258] This permits Canada Post to create regulatory barriers to entry and to otherwise raise the costs of its rivals.

G. Korea

There are three different types of SOEs in Korea: Government Enterprises, Government-Invested Enterprises, and Government-Funded Enterprises. Korea Post is a Government Enterprise, which means that it is a government entity (unlike the other forms of SOE), and the government runs Korea Post like any other government department under Korea's Ministry of Knowledge Economy. This status means that Korea Post lacks managerial autonomy that other SOE forms provide. The general regulation over enterprises under governmental control is based upon the "Act

254. CANADA POST CORPORATION STRATEGIC REVIEW SECRETARIAT, CONSULTATION GUIDANCE DOCUMENT, § 4.a.4 (2008), *available at* http://www.cpcstrategicreview-examenstrategiquescp.gc.ca/CGD-eng.PDF.

255. *See* Canada Post Corporation Act, § 6.

256. Because of the lack of a domestic solution, these issues came to play in a NAFTA arbitration claim brought by UPS Canada against Canada Post. Although UPS Canada made a number of claims about unfair competition, essentially arguing anti-competitive cross subsidization from the postal reserve to the express delivery sector, the NAFTA tribunal ruled in favor of Canada Post primarily on the grounds of Canada Post operating based on commercial, rather than government, interest. The decision made a number of assumptions on government decision-making that were not accurate, as the dissent by Ron Cass pointed out. *See* United Parcel Service of America, Inc. v. Government of Canada, International Centre for Settlement of Investment Disputes, *Award on the Merits for an Arbitration under Chapter 11 of the North American Free Trade Agreement* (June 11, 2007), *available at* http://www.international.gc.ca/trade-agreements-accords-commerciaux/assets/pdfs/MeritsAward24May2007.pdf.

257. Edward M. Iacobucci, Michael J. Trebilcock & Tracey D. Epps, *Rerouting the Mail: Why Canada Post is Due for Reform*, 243 C.D. HOWE INST. COMMENT. 1, 17–19 (2007).

258. *Id.* at 19–22.

on the Management of Public Agencies." A corporation in which the Korean government has more than 50 percent equity is subject to the Act. Regulations under the Act include appointment and dismissal of the board members, disclosure, and monitoring/audit of the corporation. The government also provides detailed rules on accounting.

In some sense, Korea Post board functions include many of the functions typical of private firms. Such functions include, for example, acquisitions of assets and operational duties involving budget, finance, and operations.[259] Korea Post publishes an annual report that contains balance sheet information and other information regarding the strategy of Korea Post, including metrics.[260]

Under the Postal Service Act, the Minister of Information and Communication oversees the organization for the delivery of mail across the country.[261] Transparency provisions are not listed. Moreover, there are no explicit safeguards against anti-competitive conduct.

Korea recently enacted a Special Law on the Governance of Korea Post.[262] Some sections of the Act address the issue of the effectiveness of management, including sections on management autonomy and the creation of an evaluative oversight committee within the Ministry of Knowledge Economy to ensure that Korea Post is run effectively.[263] Oversight duties of this committee within the government include standard board functions such as oversight of financial affairs and management results.[264] To ensure transparency and accountability, the findings of the committee must be published. Similarly, to address issues of internal control, the head of Korea Post must develop an annual management plan for approval of the Ministry of Knowledge Economy with objective criteria for measuring the success of Korea Post.[265] The lack of corporatization

259. OECD, *supra* note 223, at 139, table 6.4 (citing Framework Act on the Management of Government-Invested Institutions (as amended Jan. 28, 2000), art. 9 (Korea)).

260. *See, e.g.*, KOREA POST, ANNUAL REPORT 2008, *available at* http://www.koreapost.go.kr/eng/news/annual_report.jsp.

261. Framework Act on the Management of Government-Invested Institutions (as amended Jan. 28, 2000), art. 2 (Korea).

262. Enacted Jan. 30, 2009.

263. Framework Act on the Management of Government-Invested Institutions, art. 3–4.

264. *Id.* at art. 5(a).

265. *Id.* at art. 6(a).

suggests that a soft budget constraint limits the effectiveness of corporate governance provisions.

H. Japan

The Japanese government "privatized" Japan Post in October 2007. In fact, what occurred was a corporatization of Japan Post rather than a privatization. This is seen as a first step to eventual privatization.[266]

Japan Post Group is comprised of five corporations: Japan Post Holdings Co., Ltd. ("Holdings"), Japan Post Network Co., Ltd. ("Network"), Japan Post Service Co., Ltd. ("Service"), Japan Post Bank Co., Ltd. ("Bank"), and Japan Post Insurance Co., Ltd. ("Insurance"). Holdings is the holding company and sole shareholder (100%) of the other four corporations. The Minister of Finance is the sole shareholder (100%) of Holdings. Network provides customer services in postal, banking, and insurance operations commissioned by Service, Bank, and Insurance. It maintains 24,000 post offices. Service engages in postal services, including domestic and international mail. Bank, as its name suggests, engages in banking services. Likewise, Insurance provides life insurance. It has its own outlets, but primarily provides its services through Network's post offices.

Holdings has adopted the "Committee System" under the Companies Act, which requires a Nomination Committee, Audit Committee, and Compensation Committee within its Board of Directors.[267] From the standpoint of board independence, a majority of committee members must be appointed from among the outside directors. In terms of oversight over directors and management, the Ministry of Internal Affairs and Communications consults with the Ministry of Finance when approving matters provided under the Japan Post Holdings Corporation Act. This includes provisions such as Section 8(1) (solicitation of subscribers of share for subscription or share option for subscription, or delivery of share or share option in share exchange), Section 10 (annual business plan), and Section

266. *See* Japanese Government-sponsored study, "The Committee on Japan Post Privatization," (determining how to proceed with the liberalization of Japan Post), *available at* http://www.yuseimineika.go.jp/iinkai/dai51/51gijisidai.html (Japanese).

267. Companies Act of Japan § 2(12). Unofficial English version available at http://www.cas.go.jp/jp/seisaku/hourei/data/CA1_4_2.pdf.

11 (amendment of the corporate charter, dividend, a merger, a company split, and a dissolution of the corporate).[268]

Regarding transparency, Holdings and Service must submit their balance sheets, profit and loss statements, and business reports within three months after the end of the business year to the Minister of Internal Affairs and Communications.[269] The Corporations law requires an annual meeting. Under this law, Holdings and Service must provide public notice of the balance sheet and profit and loss statement after the conclusion of the annual shareholders meeting.[270] Balance sheets, profit and loss statements, and business reports are not made public. Of course, private corporations are not required to make such documents public, but Japan Post, though "privatized," is not yet a private corporation. As it still has universal service obligations, elements of Japan Post enjoy the benefits afforded a government monopoly but does not incur the obligations to make public its internal financial policies and practices, nor is it obligated to make transparent the process that governs the approval process required when Japan Post enters new business ventures. In other words, the processes referred to above are transparent only for those within The Ministry of Internal Affairs and Communications and Japan Post.

The duties of directors in terms of duties of care[271] and loyalty are the same as for private corporations under the Corporate Act. However, there is no explicit mandate to operate differently than publicly traded firms (i.e., to maximize profits). Rather, the only mandate on the Postal Act is for Service to maintain universal postal service.[272] These statutory requirements make Japan Post behave more like private firms. However, unlike New Zealand, there is no explicit limit to the soft budget constraint.

I. United States

The Postal Accountability and Enhancement Act (the "Act") provides the structure of government oversight of the U.S. Postal Service ("USPS") in the United States. Corporate law is a hybrid of

268. Japan Post Holdings Corporation Act § 16.

269. Japan Post Holdings Corporation Act § 12; Japan Post Service Corporation Act § 10.

270. Companies Act of Japan § 440.

271. Corporate Act of Japan § 330; Civil Code of Japan § 644.

272. Postal Act of Japan § 70.

state and federal law.[273] Federal SOEs do not have to incorporate under state incorporation laws. Because of the lack of state incorporation, corporate governance of SOEs is distinct from that of private firms.

The Act was a significant transformation for postal regulation in the United States. To solve the problem of the USPS not being a profit maximizing entity, the Act made explicit the need to push for greater efficiency. Along these lines, the Act treats the USPS more like private firms. To provide for disclosure like private corporations, the USPS needs to file quarterly reports containing the information that the SEC requires under the 1934 Act[274] for 10-Qs[275] with the Postal Regulatory Commission. Similarly, the USPS must file information that the SEC requires in annual reports for 10-Ks and 8-Ks with the Postal Regulatory Commission.[276] It also must comply with Sarbanes Oxley requirements and provide detailed financial reporting.[277]

If on the books the USPS looks like a private firm, in practice these similarities begin to vanish. USPS Board members are not individuals with significant private sector experience, especially not in large and sophisticated logistics, distribution, supply chain management, or regulated industries. Some have previous experience with the postal service, but none would have the skill set or connections one would want on the board of a private competitor such as UPS or Fed Ex. It is a warning sign about the quality of governance that over half of the USPS board members are politically connected lawyers and other operatives. The following chart illustrates the difference in the quality of board composition between USPS and its competitors among independent directors. Not surprisingly, when there is greater accountability to shareholders because of profit concerns, there are higher quality members of the board (as is the case with UPS and Fed Ex).

273. *See* Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1 (2009).

274. 15 U.S.C. § 78m, 78o(d) (2006).

275. 39 U.S.C. § 3654(a)(1)(A) (2006).

276. *Id.* § 3654(a)(1)(B) & (C).

277. *Id.* § 3654(a)(2); *id.* §3654(a)(3)(B).

CHART 1: OUTSIDE DIRECTORS COMPARISON

USPS	**UPS**	**Fed Ex**
Carolyn Lewis Gallagher (former CEO of Texwood Furniture)	Duane Ackerman (former Chairman, BellSouth)	James L. Barksdale (Chairman and President, Barksdale Management Corporation)
Louis J. Giuliano (former CEO of ITT)	Michael J. Burns (former Chairman and CEO, Dana Corporation)	John A. Edwardson (Chairman and CEO, CDW Corporation)
Mickey D. Barnett (lawyer)	Stuart E. Eizenstat (lawyer, former senior government official)	Judith L. Estrin (CEO JLABS, LLC)
James H. Bilbray (lawyer and former Congressman)	Michael L. Eskew (former chairman and CEO, UPS)	J.R. Hyde III (Chairman GTx, Inc.)
Thurgood Marshall, Jr. (lawyer)	William R. Johnson (Chairman and CEO, H.J. Heinz)	Shirley A. Jackson (President, Rensselaer Polytechnic Institute)
James C. Miller III (former senior government official)	Ann M. Livermore (Exec. VP, Hewlett-Packard)	Steven R. Loranger (Chairman and CEO, ITT Corporation)
Ellen C. Williams (lobbyist, former government official)	Rudy Markham (former CFO, Unilever)	Gary W. Loveman (Chairman and CEO, Harrah's Entertainment)
	John W. Thompson (former CEO, Symantec)	Susan C. Schwab (former senior government official)
	Carol Tome (CFO, Home Depot)	Joshua I. Smith (Chairman and Managing Partner, Coaching Group, LLC)
		David P. Steiner (CEO, Waste Management)
		Paul S. Walsh (CEO, Diageo)

Historically there has been a problem of an ineffective regulator of the postal service. Empirical evidence shows that anti-competitive cross-subsidization occurred under the old postal regulatory regime.[278] The old regulator, the Postal Rate Commission, was an inadequate regulator that could not adequately check on anti-competitive practices of the USPS. The old Postal Rate Commission lacked the subpoena power over the USPS and the ability to mandate that the USPS provide it with data; whatever data the Commission received came voluntarily from the USPS.[279] This

278. *See generally* Geddes, *supra* note 170, at 575.

279. *See* R. Richard Geddes, *Reform of the U.S. Postal Service*, 19 J. ECON. PERSP. 217, 219 (2005).

differed from most other U.S. federal agencies at the time. More importantly, the lack of subpoena power created information asymmetries between the USPS and its regulator, which the USPS could and did exploit to limit competition.[280] The new Act corrects a number of these deficiencies. There is now the authority to issue subpoenas.[281] Anti-competitive cross-subsidization from the reserve to the competitive sector is no longer permitted.[282] As a result of the Act, the USPS is subject to antitrust laws.[283] This reflects a legislative change as a response to the United States Supreme Court's decision in *United States Postal Service v. Flamingo Industries* discussed below.[284] One of the explicit goals of the new regulator, the Postal Regulatory Commission, is "[t]o allocate the total institutional costs of the Postal Service appropriately between market-dominant and competitive products."[285] Appropriate cost allocation will reduce the opportunity for the USPS to engage in anti-competitive cross-subsidization as it has done in the past. As part of this mandate, the legal mandate is that "each class of mail or type of mail service bear the direct and indirect postal costs attributable to each class or type of mail service through reliably identified causal relationships plus that portion of all other costs of the Postal Service reasonably assignable to such class or type."[286] If followed, this type of cost accounting would do much to protect against potential anti-competitive cross-subsidization. Moreover, the Act explicitly limits this anti-competitive cross subsidy in terms of setting rates:

> § 3633. Provisions applicable to rates for competitive products
>
> (a) IN GENERAL.—The Postal Regulatory Commission shall, within 18 months after the date of enactment of this section, promulgate (and may from time to time thereafter revise) regulations to—
>
>> (1) prohibit the subsidization of competitive products by market-dominant products;

280. *See supra* note 236 (providing evidence of cross-subsidization).
281. 39 U.S.C. § 504(f)(2)(A) (2006).
282. 39 U.S.C § 3633(a) (2006).
283. 39 U.S.C § 409(e)(1)(B) (2006).
284. 540 U.S. 736 (2004).
285. 39 U.S.C § 3622(b)(9) (2006).
286. *Id*. § 3622(c)(2).

> (2) ensure that each competitive product covers its costs attributable; and
>
> (3) ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.[287]

These explicit prohibitions suggest governance mechanisms to solve some of the worst competition problems. It is too early to tell whether the law will prove effective, but on paper this is certainly an improvement over the previous internal and external governance of the USPS.

Competition concerns remain a problem. Like many countries, the United States provides a statutory monopoly for mail. The USPS has the ability to shape the definition of what can be included in the protected sector through size and weight restrictions. The USPS has a lower cost of capital than potential private firm competitors because of government credit guarantees. Unlike private firms, the USPS has the power of eminent domain and self zoning. This suggests that soft budget constraints remain, even with the changes under the Act.

An FTC report estimates that the value of government subsidies that the USPS allocates to competitive products by virtue of its government status to be in the range of $38 million to $113 million. The various implicit subsidies include such categories as not having to pay parking tickets or tolls.[288] The FTC Report does not impute some critical categories in terms of advantages for the postal service in the competitive sector. For example, it does not impute the reduced cost of capital due to what is effectively a U.S. government guarantee that determines the USPS rate for debt.[289] Moreover, the report does not impute the value of the postal monopoly as one of the benefits of the USPS.

This is not to suggest that there are not costs associated with being the USPS. The FTC estimates that the current legal regime imposed costs on the USPS of $213 to $743 million higher than costs might be otherwise if it did not have these extra costs

287. 39 U.S.C § 3633(a).

288. FEDERAL TRADE COMMISSION, ACCOUNTING FOR LAWS THAT APPLY DIFFERENTLY TO THE UNITED STATES POSTAL SERVICE AND ITS PRIVATE COMPETITORS 57 (2007), http://www.ftc.gov/os/2008/01/080116postal.pdf.

289. *Id.* at 58.

associated with its government mandate.[290] These numbers only tell part of the story as the FTC provides the disclaimer: "This range is based only on estimates of those burdens and benefits that we have been able to quantify."[291] However, the FTC does not seem to adjust costs based on an accurate baseline. A firm that had a profit maximizing mission would not be in the same situation as the USPS; it would not have a bloated labor pool that would account for 80 percent of costs, which is out of line with other postal providers.[292]

Most importantly, the current USPS obligations under law exist because of the lack of competition. The government has foreclosed competition, which saddles the USPS with various regulatory obligations that a more efficient competitor could provide. Injecting competition and more market pressure to the U.S. Postal market should lead to efficiency gains. Thus, an accounting of the implicit subsidies would make the USPS a more efficient firm and force it to behave more like a private firm. This would also require the USPS to act more like a private firm in its corporate governance. A reduction or elimination of the postal monopoly could be the impetus for a transformative change at the USPS far more than what the Postal Accountability Act has created. While it may be possible under current U.S. law for a test that imputes these costs to determine the true costs, the Postal Rate Commission has yet to devise it.[293]

V. COMPETITION AND SOEs

Ex ante, the competition issues involving SOEs can be addressed somewhat by corporate governance in terms of structuring the incentives of a firm to behave more like private firms, with an efficiency rationale. Without soft budget constraints, an SOE cannot get away with predatory pricing so easily. Ex post, competitive distortions can be solved through antitrust, which provides the potential of relief against anti-competition abuses.

A. Incentives for SOE Anti-Competitive Behavior

Competition is the foundation for a market economy. Market competition profoundly affects firms by eliminating inefficient

290. *Id.* at 64.
291. *Id.* at 64 n.287.
292. *Id.* at 80.
293. 39 U.S.C. § 3633 (2006).

firms.[294] Moreover, it can make the monitoring of firms more effective.[295]

Governments may erect many types of regulatory barriers to limit competition.[296] For example, bias by the government to protect SOEs may take the form of favorable lending rates vis-à-vis private firms. SOEs therefore may have a different cost of capital than do private firms. This may have an effect of an implicit subsidy for SOEs. Government may open its purse to provide for lower borrowing rates than market rates. SOEs also may benefit from discriminatory regulation. SOEs may not be required to pay taxes or may be immune from antitrust. Moreover, SOEs may benefit from information asymmetries. Information asymmetries occur where SOEs have data that private competitors do not where the government collects the data. An SOE can use its economies of scope to create high barriers to entry that effectively forecloses competition by efficient competitors.[297] Because of cost structure and incentives of an SOE, SOEs are more successful in their attempts to prevent foreign entry than similarly situated private firms.[298] This Part will explain the postal competition issues present in antitrust with the twist that the firms involved in potential anti-competitive conduct are SOEs. Because of the soft budget constraint, SOEs do not face the same sorts of costs that private firms do in an antitrust inquiry. Thus, as this Part will demonstrate, it is possible for SOEs to engage in predatory pricing without fear of antitrust liability based on existing antitrust methodologies. Likewise, this Part will show that it is possible for SOEs to engage in behavior that raises rivals'

294. *See* Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950).

295. *See generally* Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981); Barry J. Nalebuff & Joseph E. Stiglitz, *Prizes and Incentives: Towards a General Theory of Compensation and Competition*, 14 BELL J. ECON. 21 (1983) (applying tournament theory of who to promote).

296. *See* Eleanor M. Fox, *Economic Development, Poverty, and Antitrust: The Other Path*, 13 SW. J. L. & TRADE AM. 101, 114 (2007); William E. Kovacic, *Lessons of Competition Policy Reform in Transition Economies for U.S. Antitrust Policy*, 74 ST. JOHN'S L. REV. 361, 401 (2000); Timothy J. Muris, *Principles for a Successful Competition Agency*, 72 U. CHI. L. REV. 165, 170 (2005).

297. John C. Panzar, *Interactions Between Regulatory and Antitrust Policies in a Liberalized Postal Sector*, 5 (Northwestern Univ., Univ. of Auckland, Working Paper, 2008).

298. Anusha Chari & Nandini Gupta, *Incumbents and Protectionism: The Political Economy of Foreign Entry Liberalization*, 88 J. FIN. ECON 633 (2008).

costs with reduced risk of effective antitrust prosecution than similarly situated private firms.

1. Revenue maximization as an SOE goal

Because of the soft budget constraint, SOEs may have goals other than profit maximization such as revenue maximization.[299] Government support of SOEs through government created distortions (e.g., a large reserve sector, implicit loan guarantees, preferences for zoning) allows SOEs to price below its marginal cost due to the explicit and implicit subsidies that governments grant SOEs and not their private competitors. This creates a situation, unlike the typical U.S. antitrust predation case, which does not require recoupment for successful SOE predation.[300]

In the postal context the concern is that the postal incumbent can exclude based on an anti-competitive cross subsidy to the competitive sector from the reserve sector and not have to recoup costs because of the soft budget constraint. The ability of SOEs to engage in non-recoupment predatory pricing poses an important question. If consumers do not see higher prices as a result of the predation, is there any consumer harm? When an SOE can pursue a successful predation strategy, this reduces the resources of a competitor to innovate or operate. The "but for" case is that there might have been even lower prices and more innovation. Successful predation also may have reputational effects if a firm competes in multiple product markets. This reputational effect creates a credible threat that allows firms to reap the benefits of predation even in markets in which they did not predate. This in turn negatively affects the overall market. Paul Milgrom explains:

> Thus, for example, a firm in an industry with rapid product change might cut prices sharply in answer to new entry in order to discourage the new entrant from continuing an active product development programme. Whether the entrant attributes its lack of profitability to its high costs, to weak market demand, to overcapacity in the industry, or to aggressive behaviour by its

299. *See* JOHN R. LOTT, JR., ARE PREDATORY COMMITMENTS CREDIBLE? WHO SHOULD THE COURTS BELIEVE? 77 (1999) ("[G]overnment enterprises also face higher returns from below-cost pricing since they benefit not only from the long-term reduction in competition, but also from the short-term increase in their output required to undertake the below-cost pricing strategy.").

300. *See* Sappington & Sidak, *supra* note 153, at 522–23.

> competitor, it will properly reduce its estimate of its future profits. If its capital has other good uses, this might lead it to withdraw from the industry. If not, it may nevertheless be dissuaded from making new investments in and developing new products for the industry. At the same time, other firms may be deterred from entering the industry. If *any* of these things happen, the predator benefits.[301]

When predator firms benefit, this reduces consumer welfare.[302] Predation must be distinguished from raising a rival's cost.[303] Predation in non-SOE settings requires antitrust officials to think about short run benefits versus long run costs. In raising the cost of rivals, the goal is to increase the price of output for rivals rather than decrease price. A successful raising of a rival's cost strategy would be one in which the dominant firm's average costs increase less than the incremental costs of a rival. This allows a dominant firm to create an asymmetric impact on costs relative to its rivals.[304]

The ultimate goal of raising a rival's cost is different than predation. A successful raising rival's cost strategy does not require the firm with higher costs to exit the market, but merely to allow the dominant firm to raise its price above the competitive level.[305] As Sappington and Sidak suggest, "Consequently, even though an SOE may value the profit that its anticompetitive activities can generate less highly than does a private profit-maximizing firm, the SOE may still find it optimal to pursue aggressively anticompetitive activities that expand its own output and revenue."[306] Given that an SOE may have revenue rather than revenue enhancement objectives, it can

301. Paul Milgrom, *Predatory Pricing*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS 937, 938 (John Eatwell, Murray Milgate & Peter Newman eds., 1987).

302. An increasing economic literature notes that predatory pricing may be rational in other settings for profit maximizing firms as well. *See* Patrick Bolton, Joseph F. Brodley & Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2241 (2000) (describing that "modern economic analysis has developed coherent theories of predation that contravene earlier economic writing claiming that predatory pricing conduct is irrational" and thus that "the consensus view in modern economics [is] that predatory pricing can be a successful and fully rational business strategy").

303. Deborah Cope, *Regulating Market Activities in Public Sector*, 7 OECD J. COMPETITION L. & POL'Y 32, 38–40 (2005); Sappington & Sidak, *supra* note 153, at 496.

304. STEPHEN MARTIN, ADVANCED INDUSTRIAL ECONOMICS 244–46 (2d ed. 2002).

305. Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209, 242 (1986).

306. Sappington & Sidak, *supra* note 153, at 499.

more effectively absorb the cost of raising the costs than its private rivals. It can do so because the government acts to constrain rival firms.[307] When an SOE can pursue an effective raising of a rival's cost strategy, it can expand its scope. Predation or raising rivals' costs takes away the ability for competitors to invest in increase research and development and limits the ability to roll out new products and services and processes that increase dynamic gains from innovation.[308] SOEs may have particular incentive to raise the costs of its rivals. As the rival's marginal cost increases, it may be costly to the SOE, but it simultaneously increases the demand for the SOE's product or service. Since the SOE is a revenue maximizer, it benefits from the increased demand.[309]

B. Antitrust Solution

Monopolization creates a consumer welfare loss. There are a number of different cost based tests that antitrust law uses to combat predatory pricing abuses.[310] In some cases, an antitrust solution is impossible because of a direct antitrust immunity for SOEs or for a sector such as postal. Public choice explains in part why, a large number of postal markets remain closed to competition and why, in some cases, antitrust remedies for anti-competitive postal services behavior of may not be possible.[311] Like other network industry incumbents with monopoly privileges, postal incumbents will fight attempts to liberalize their markets in the name of the public interest, even when private interests might be the true motivation. With their large number of voters, postal workers can block legislation such as the closure of post offices in small or rural

307. David T. Scheffman & Richard S. Higgins, *Twenty Years of Raising Rivals' Costs: History, Assessment, and Future*, 12 GEO. MASON L. REV. 371, 376 (2003).

308. Eleanor M. Fox, *U.S. and European Merger Policy—Fault Lines and Bridges: Mergers That Create Incentives for Exclusionary Practices*, 10 GEO. MASON L. REV. 471, 474 n.14 (2002) (citing United States v. Microsoft Corp., 253 F.3d 34, 50–53 (D.C. Cir. 2001)).

309. Sappington & Sidak, *supra* note 155, at 196–97.

310. Raising rival's cost is not a judicial antitrust claim but is a theoretical tool to frame exclusionary behavior. Oftentimes courts use the theory of raising rival's costs without explicit mention of it.

311. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

locations that are too costly.[312] For example, there are similar numbers of postal employees as lawyers in the United States.[313] Since SOEs may have an employment maximization goal in addition to a revenue maximization goal, this may play into the public choice both for the SOE and for elected officials who can satisfy constituent groups with increased numbers of jobs.[314]

Antitrust may be a possible solution to anti-competitive conduct when there is no direct immunity to postal behavior. However, a lack of immunity does not entail that antitrust will be an effective tool to remedy anti-competitive conduct. In many cases, SOEs may be dominant in their relevant markets; certainly this is true in the postal sector where statutory monopoly protects the reserve sector. When this is the case, SOEs have the potential to monopolize. This makes the ability to utilize antitrust effectively more important. Yet, domestic antitrust law may not apply the types of analytical tools to remedy anti-competitive conduct by SOEs. Part II explored the dynamics of SOEs' incentives other than profit maximization. Specific to the antitrust context, the general state of antitrust law enforcement in most jurisdictions does not recognize that sustained predation below cost is possible without recoupment, because it is based on the premise of profit maximizing firms rather than employment and/or revenue maximizing firms. Moreover, antitrust law is ill-equipped to address predation by SOEs because antitrust uses the same cost test for both private firms and SOEs. That is, current antitrust tests do not impute the various government preferences into the actual costs of SOEs.

Many antitrust agencies may use one or more of the tests depending on the particular industry and factual situation in its investigations. This Article focuses on the cost tests used in case law developed from fully litigated cases rather than from agencies' stated preferences and use of different tests in investigations.[315] It does so

312. Géradin & Sidak, *supra* note 146, at 163; Patricia L. Maclachlan, *Post Office Politics in Modern Japan: The Postmasters, Iron Triangles, and the Limits of Reform*, 30 J. JAPAN. STUD. 281 (2004).

313. GEDDES, *supra* note 163, at 1. The total number of USPS employees is in the range of 700,000 to 900,000. This would make the USPS the second largest private employer in the U.S. (between Wal-Mart and McDonalds) and the fourth largest non-military employer in the world. *Congress Has Mail*, WALL ST. J., Dec. 26, 2006, at A12.

314. *See* GEDDES, *supra* note 163, at 32–33, 83–86.

315. A number of agencies have reflected how they view predatory pricing cases in their jurisdictions. *See* INTERNATIONAL COMPETITION NETWORK, UNILATERAL CONDUCT

because, from the standpoint of measuring results, it is easier to understand and compare cases as outputs rather than investigations that may have been dropped by an agency or party for any number of reasons. Measuring cases provides for greater predictability even though it may not reflect undercurrents in practice in a given country based on agency guidelines on agency investigations that never result in a decision. Competition laws are broad. Therefore, much of the "action" is in case law. This Part surveys the leading predatory pricing cases across jurisdictions and notes where there has been a predatory pricing case brought against an SOE.[316]

1. Average variable cost

Marginal cost is the cost of the additional production of a unit of output based on short run marginal costs. Costs below marginal cost would be presumed unlawfully predatory. The problem with using marginal cost is that it is difficult to measure. Areeda and Turner suggested the use of average variable costs ("AVC") as a proxy for marginal cost.[317] Average variable costs are costs that vary depending on the level of output produced.[318] This test seems to be the most popular among U.S. courts. As the leading antitrust treatise notes, "[n]umerous decisions have concluded that [average variable cost] is at least the presumptive baseline for determining predation."[319]

WORKING GROUP QUESTIONNAIRE ON PREDATORY PRICING AND EXCLUSIVE DEALING/SINGLE BRANDING AND RESPONSES (2007), http://www.internationalcompetitionnetwork.org/index.php/en/working-groups/unilateral-conduct/unilateral-conduct-working-group-and-responses-2007 (antitrust agency responses to a questionnaire on predatory pricing).

316. To the author's knowledge, there is no case around the world in which SOE predation is treated differently than private firm predation, analytically.

317. Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 700–03 (1975). This is the most cited law review article in U.S. courts on any antitrust issue. Many foreign courts also cite to it in their discussion of predatory pricing. A number of professors have taken issue with Areeda and Turner but accept the underlying premise of the AVC test that, in a static world, marginal price pricing is optimal. *See* Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 CORNELL L. REV. 1, 32–35 (2005) (providing a review of the critiques).

318. DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 29 (4th ed. 2005).

319. PHILLIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 425, ¶ 740a (2d ed. 2002).

Nevertheless, a number of other cost based tests are available, and a number of writers have shown the limitations of AVC.[320]

2. Average avoidable cost

Antitrust agencies around the world seem to be shifting to the average avoidable cost ("AAC") test.[321] Average avoidable costs consist of the costs (including variable and fixed costs) that could have been avoided had there been no predatory pricing. Average avoidable costs exclude sunk fixed costs that preceded the predatory pricing.[322] This test is advantageous because, by including both fixed and variable costs, it reduces classification problems of fixed versus variable costs, which are inherent to the use of an average variable cost test. The premise behind AAC is that a price below AAC by necessity involves a sacrifice of profits and will exclude equally efficient rivals.[323]

3. Long run average incremental cost

The final cost test generally used in predation cases is long run average incremental cost ("LRAIC"). This test, in contrast to AAC, includes sunk fixed costs even when the sunk costs occurred prior to the predatory pricing. LRAIC is the "per unit cost of producing the predatory increment of output whenever such costs were incurred."[324] This test is particularly useful in areas such as software or pharmaceuticals because "the average variable costs of computer software continuously decline and may approach insignificance as sales volume becomes sufficiently high."[325] LRAIC may, in certain circumstances, also be the cost test of choice in regulated industries in which the predation may occur in related products or services.

320. *See, e.g.*, Jonathan B. Baker, *Predatory Pricing After Brooke Group: An Economic Perspective*, 62 ANTITRUST L.J. 585 (1994); Bolton et al., *supra* note 302, at 2242–62.

321. U.S. DEPARTMENT OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 65 (2008), *available at* http://www.justice.gov/atr/public/reports/236681.pdf.

322. CARLTON & PERLOFF, *supra* note 275, at 29 n.27. ("A sunk cost is like spilled milk. Once it is sunk, there is no use worrying about it, and it should not affect any subsequent decisions. . . . Costs, including fixed costs, that are not incurred if operations cease are called avoidable costs.").

323. William J. Baumol, *Predation and the Logic of the Average Variable Cost Test*, 39 J.L. & ECON. 49, 57–61 (1996).

324. Bolton et al., *supra* note 302, at 2272.

325. *Id.* at 2273.

This test has been attacked because of the difficulty of imputing costs, its effects on potential pro-competitive price cutting, and because the cost cutting might not have an exclusionary effect.[326]

The following table explains, by jurisdiction, the various predatory price tests employed in case law. Though antitrust agencies may utilize different tests in their investigations, this chart limits the inquiry to decided cases because it is easier to measure what jurisdictions have done. Where there are no cases in which a jurisdiction uses a particular test, it is noted with a "No" response.

TABLE 1: COMPARATIVE PREDATORY PRICING TEST

Jurisdiction	**Pricing test**	**Utilized in case law (rather than in theory)?**	**Representative Cases**
United States[327]	Below AVC	Yes	*Stearns Airport Equip. Co. v. FMC Corp.*, 170 F.3d 518, 532 (5th Cir. 1999); *Advo, Inc. v. Phila. Newspapers, Inc.*, 51 F.3d 1191 (3d Cir. 1995); *Arthur S. Langenderfer, Inc. v. S.E. Johnson Co.*, 729 F.2d 1050, 1056 (6th Cir. 1984); *Ne. Tel. Co. v. AT&T Co.*, 651 F.2d 76 (2d Cir. 1981).
	Below AAC	Yes	*United States v. AMR Corp.*, 335 F.3d 1109, 1115–16 (10th Cir. 2003).
	Below LRAIC	Yes	*MCI Commc'ns Corp. v. AT&T Co.*, 708 F.2d 1081 (7th Cir. 1982).
	Below ATC	No	*McGahee v. N. Propane Gas Co.*, 858 F.2d 1487, 1500 (11th Cir. 1988).
European Commission	Below AVC	Yes	Case 62/86 *AKZO Chemie BV v. Commission* [1991] ECR I-3359.

326. Kenneth G. Elzinga & David E. Mills, *Predatory Pricing and Strategic Theory*, 89 GEO. L.J. 2475, 2484 (2001).

327. The leading Supreme Court case in this area, *Brooke Group*, does not specify a particular test. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222 (1993).

	Below AAC[328]	No	
	Below LRAIC	Yes	COMP/35.141- *Unitel Parcel Service/DP AG*, 20 Mar. 2001.
	Below ATC	Yes	*France Télécom v. Commission* (ECJ 2 Apr. 2009).
United Kingdom[329]	Below AVC	Yes	*Aberdeen Journals Ltd. v. The Office of Fair Trading*, [2003] CAT 11, 2003 All E.R. (D) 137, ¶ 380.[330]
	Below AAC	Yes	*Cardiff Bus v. The Office of Fair Trading* [2008].[331]
	Below LRAIC	No	N/A
	Below ATC	No	N/A
Sweden	Below AVC	Yes	Statens Järnvägar MD 2000:2.
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	No	N/A
Chile	Below AVC	Yes	Decision No. 39, *James Hardie Fibrocementos Limitada*, sentence of the Supreme Court of November 29, 2006, sentence of the Tribunal for the Defense of Competition of June 13, 2006.
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	No	N/A
South Africa	Below AVC	Yes	*Nationwide Airlines and S. Afr.*

328. This test is the current policy preference of the Commission. DIRECTORATE-GEN. FOR COMPETITION, EUROPEAN COMM'N, DISCUSSION PAPER ON THE APPLICATION OF ARTICLE 82 OF THE TREATY TO EXCLUSIONARY ABUSES 31 (2005), *available at* http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf.

329. Many SOEs in the UK will be incorporated as legal company entities and will be treated exactly the same as privately owned equivalents. For such companies, competition law should apply on exactly the same basis. Non-incorporated SOEs would be regulated by their parent departments. It is possible, under such circumstances, that a situation of predation would be addressed through administrative hearings.

330. The Court mentioned that "the cost-based rules set out in AKZO and Tetra Pak II, while providing guidance, are not an end in themselves," and the guidance therein was "open to further development." Aberdeen Journals Ltd. v. The Office of Fair Trading, [2003] CAT 11, 2003 All E.R. (D) 137, ¶ 380.

331. The OFT noted that "[i]n past cases [AVC and AAC] have been shown to be very similar, since any cost that is variable over the period is also avoidable." *Id.* at 7.156.

			Airways (92/IR/Oct00).
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	No	N/A
South Korea[332]	Below AVC	No	N/A
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	No	N/A
	Other—Below the normal trade price	Yes	*Cadland*, *Samsung Tesco*, *Ahnkook*, *Lucky*, *Sangyong*.
New Zealand[333]	Below AVC	No	N/A
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	No	N/A
Canada	Below AVC	Yes	*R. v. Hoffmann La Roche Ltd.* (1980), 28 O.R. (2d) 164 (H.C.J.), affirmed 33 O.R. (2d) 694 (C.A.); *R. v. Consumers Glass Co.,* (1981), 33 O.R. (2d) 228.
	Below AAC	Yes[334]	*Canada (Director of Investigation and Research) v. Air Canada* (2003), 26 C.P.R. (4th) 476.
	Below LRAIC	No	N/A
	Below ATC	No	N/A

332. South Korea does not use a cost based test for predatory pricing.

333. There is only one case to date (Carter Holt Harvey Bldg. Prods. Group Ltd. v. Commerce Comm'n, [2006] 1 N.Z.L.R. 145 (P.C.)). The case is not explicit as to the particular price test, though the New Zealand Competition Commission has used both AVC and AAC in investigations. This case law is analogous to that of Australia, which New Zealand looks to for support. *See* Boral Besser Masonry Ltd. v. Austl. Competition and Consumer Comm'n (2003) 215 C.L.R. 374 (Australian predatory pricing which also does not explicitly adopt a particular price test). There is no predatory pricing case specific to New Zealand SOEs.

334. In *Air Canada*, the particular AAC test was statutorily mandated by the law that addressed airlines. Since then, the preference for the Competition Bureau is for the AAC test more generally. COMPETITION BUREAU, CAN., ENFORCEMENT GUIDELINES: PREDATORY PRICING 1415 (2008), *available at* http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/vwapj/Predatory_Pricing_Guidelines-e.pdf/$file/Predatory_Pricing_Guidelines-e.pdf. There have not been any predatory pricing decisions since *Air Canada*.

Japan	Below AVC	Yes	*Daikoku*
	Below AAC	No	N/A
	Below LRAIC	No	N/A
	Below ATC	Yes	*Hamaguchi Petroleum*

V. PRICING TESTS BY JURISDICTION

A. United States

The basis for monopolization claims under U.S. antitrust law derives from Section 2 of the Sherman Act.[335] Case law has developed regarding the appropriate test to use for predation, though at lower court levels the standards are still not exactly clear.[336] The seminal Supreme Court case in this area is *Brooke Group v. Brown & Williamson Tobacco Corp.*[337] Under *Brooke Group*, two factors must be met in a successful predatory pricing claim. First, a plaintiff must show that the prices at issue "are below an appropriate measure of its rival's costs."[338] Second, there must be a showing "that the competitor had . . . a dangerous probability, of recouping its investment in below-cost prices."[339] Two recent Supreme Court cases, *Linkline*[340] and *Weyerhauser*, [341] upheld the *Brook Group* approach. Circuit courts across the United States have interpreted the *Brook Group* case differently.[342] For example, in *United States v. AMR Corp.*, the Fifth Circuit "decline[d] to dictate a definitive cost

335. 15 U.S.C. § 2.

336. Crane, *supra* note 317, at 7–9 (also noting that plaintiffs recast predatory behavior into other antitrust classifications of harm to overcome courts' reluctance to find for plaintiffs on predation claims). On the interaction of rules and standards generally within antitrust, see Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 WASH. & LEE L. REV. 49 (2007).

337. 509 U.S. 209 (1993).

338. *Id.* at 222.

339. *Id.* at 224.

340. Pacific Bell Tel. Co. v. Linkline Commc'n, Inc., 129 S. Ct. 1109 (2009) (supporting the use of predatory pricing tests in the retail cost context of a price squeeze claim).

341. Weyerhaeuser Co. v. Ross-Simmons Hardwood Co., 549 U.S. 312, 315 (2007) (upholding the cost test in predatory buying circumstances).

342. Crane, *supra* note 317, at 4 (stating that the Supreme Court has not resolved circuit splits in the lower courts over fundamental predatory pricing issues).

measure for all cases" although it used an average avoidable cost test in that particular case.[343]

One reason that there are few predatory pricing cases is because of the Supreme Court's concern of the potential for type II errors of mistake prosecution. As the Supreme Court notes, "mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect."[344] As such, the Court has created various procedural hurdles for plaintiffs in predatory pricing cases. Many of the same behaviors that could lead to allegations of predatory pricing are precisely the ones that could increase competition, such as price cuts. The Supreme Court most recently restated this explicitly in *Weyerhaeuser*:

> The costs of erroneous findings of predatory-pricing liability are quite high because the mechanism by which a firm engages in predatory pricing—lowering prices—is the same mechanism by which a firm stimulates competition, and therefore mistaken liability findings would chill the very conduct the antitrust laws are designed to protect.[345]

1. U.S. Postal Service—a competition policy problem

There are a number of reasons why SOE antitrust cases are not typical in the United States. Many are state action cases that involve decisions based on whether or not the state action has been clearly articulated rather than on substantive claims of anti-competitive conduct. However, there has been a recent Supreme Court case regarding not merely an SOE, but a postal SOE. As with other U.S. cases involving SOEs, this case was not decided on the merits but on whether or not antitrust immunity applied.[346]

The Supreme Court found that the Sherman Act did not apply to the post office in *United States Postal Service v. Flamingo*

343. United States v. AMR Corp., 335 F.3d 1109, 1116 (10th Cir. 2003).

344. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986).

345. *Weyerhaeuser Co.*, 549 U.S. at 312 (citing *Brooke Group*, 509 U.S. at 226) ("The costs of erroneous findings of predatory-pricing liability are quite high because the mechanism by which a firm engages in predatory pricing—lowering prices—is the same mechanism by which a firm stimulates competition, and therefore mistaken liability findings would chill the very conduct the antitrust laws are designed to protect.").

346. U.S. Postal Serv. v. Flamingo Indus., 540 U.S. 736, 739–48 (2004).

Industries.[347] Among the claims that Flamingo made was that the USPS sought to create a monopoly in mail sack production, and that it could do so in large part because of its monopoly in the postal reserve sector.[348] In *Flamingo*, the Supreme Court stated that the USPS was a part of the federal government and therefore not under the purview of the antitrust laws of the United States.[349] In a departure from the prevailing economic literature on SOEs, the Supreme Court reasoned that the USPS' "powers are more limited than those of private businesses. It lacks the prototypical means of engaging in anti-competitive behavior: the power to set prices."[350] Under this flawed reasoning, an SOE does not have an incentive to drive competitors out of business. As discussed earlier in this Article, economic theory suggests that an SOE may have other motivations than profit maximization. Even if an SOE does concern itself at times with profit, it is also motivated by revenue maximization and by an interest in increasing the scope of its services and its number of employees.[351] The reasoning of the Supreme Court ignores the possibility of no-recoupment predation because of government ownership and of raising rivals' cost strategies.

A second weakness of the Supreme Court decision was its reliance on the Postal Commission, the sector regulator, to overcome potential anti-competitive behavior by the USPS.[352] The old Postal Rate Commission lacked a subpoena power and the ability to mandate that the USPS provide it with data. Whatever data it received came voluntarily from the USPS.[353] Such a situation created additional information asymmetries between the regulator and the regulated industry and makes it more difficult to detect the anti-competitive cross subsidies between the postal and express delivery sectors.

Because of the weakness of the postal regulator, antitrust would have been the only alternative to remedy the anti-competitive

347. *Id*. at 736. Since then, the 2007 Act explicitly allows for the application of antitrust to the USPS.

348. *Flamingo*, 540 U.S. at 738–39.

349. *Id*. at 739–48.

350. *Id*. at 747.

351. Sappington & Sidak, *supra* note 153, at 479; *see also* Rick Geddes, *Do Vital Economists Reach a Policy Conclusion on Postal Reform?*, 1 ECO. J. WATCH 61 (2004).

352. *Flamingo,* 540 U.S. at 747.

353. Geddes, *supra* note 279, at 219.

behavior. The Postal Commission that existed at the time of the decision in 2004 was a weak regulator. Unlike regulators in other network industries such as electricity or telecommunications, the Postal Commission could not set rates. Rather, it could only recommend rate changes, and such recommendations can be overridden by the USPS board of directors.[354] Yet, somehow, in spite of a regulator that lacks the ability to set prices and to have its dictates followed, the Court found that regulatory oversight was a factor that prevented USPS from monopolization.[355]

In any determination of whether to bring an antitrust case, the first and perhaps most important issue is one of assembling evidence. Even if the USPS was subject to antitrust law at the time, bringing such a case would have been very difficult, even if there had been an effective measure of cost predation that took into account the government advantages granted to the USPS. The existing U.S. predatory pricing methodologies, as noted in the previous discussion, required recoupment.[356] While this might make sense for private firms that operate based on profit, a cost based test is ineffective for government owned firms with soft budget constraints that might maximize revenue rather than profit.

Flamingo also underscores how important the predation and raising rival's cost claims are in terms of understanding the potential anti-competitive harm on the part of the postal service. Since the USPS defines the size of its reserve sector broadly, it has an incentive to increase the definition of the reserve sector to reduce competition.[357] This limits the potential scope and scale of competitors in the non-reserve and related sectors.[358] The USPS also has a unique monopoly over the mailbox itself, a monopoly found in no other nation.[359]

354. 39 U.S.C. §§ 3625, 3628. These statutes have been repealed as of Dec. 20, 2006.

355. *Flamingo*, 540 U.S. at 740–41.

356. *See* Sappington & Sidak, *supra* note 300 and accompanying text.

357. Compare the U.S. reserve sector to the EU's postal liberalization, which significantly reduces the reserve sector. EUR. PARL. ASS., *Directive 97/67/EC*, as amended by *Directive 2002/39/EC* (1997).

358. This is particularly true when the SOE exhibits cost complementarities in its production technology. *See* Sappington & Sidak, *supra* note 155, at 198 n.39.

359. *See* U.S. Postal Serv. v. Council of Greenburgh Civic Ass'ns, 453 U.S. 114 (1981); R. Richard Geddes, *Anticompetitive Behavior in Postal Services*, *in* COMPETING WITH THE GOVERNMENT: ANTICOMPETITIVE BEHAVIOR AND PUBLIC ENTERPRISES 88 (R. Richard Geddes ed., 2004); Géradin & Sidak, *supra* note 146, at 163.

Under the Postal Act in place at the time of *Flamingo*,[360] the U.S. government offered the USPS credit guarantees through direct borrowing from the Federal Financing Bank. The credit guarantee allowed the USPS to provide a 12.5 basis point premium for its debt above the U.S. Treasury bond rate.[361] Furthermore, this financing provided lower rates for the USPS than private firms. The Supreme Court failed to understand that the USPS has the power of eminent domain. It also has the power to self zone, while express delivery competitors must apply for local zoning permits.[362] Private firms must go through the costly and time consuming process to set up an effective distribution network.

Competition in postal and express delivery was not robust under the old Postal Act. Evidence suggests that the USPS used its monopoly over delivery to cross subsidize its express delivery service where it faced competition.[363] This behavior can be traced to the 1970 Postal Reorganization Act. The Act increased cross subsidies to the competitive mail classes.[364] For example, the rate increase of first class post to twenty-five cents occurred while the Postal Service decreased the price of next day express service, even though the express service arm was already in the red.[365] This postal rate increase coincided with a reduction in the amount charged on foreign express delivery by the USPS from $18 to $8.75.[366] As a result, the USPS shipped 66% more express mail packages than it had the year before.[367]

B. European Union

Article 82 is the Treaty of Rome article that addresses the abuse of a dominant position under EC law and, therefore, the basis for a predatory pricing claim. A number of different elements make up the

360. The new Postal Reorganization Act of 2007 was in part a consequence of *Flamingo*.

361. R. Richard Geddes, *Case Studies of Anticompetitive SOE Behavior*, *in* COMPETING WITH THE GOVERNMENT: ANTICOMPETITIVE BEHAVIOR AND PUBLIC ENTERPRISES 30–31 (R. Richard Geddes ed., 2004).

362. *Id.* at 34.

363. Geddes, *supra* note 359, at 93–97.

364. GEDDES, *supra* note 163, at 5.

365. JOHN R. LOTT, ARE PREDATORY COMMITMENTS CREDIBLE? WHO SHOULD THE COURTS BELIEVE? 69 (1999).

366. *Id.*

367. *Id.*

criteria for a predatory pricing case for purposes of EC law. These are sacrifice, anti-competitive foreclosure, and efficiencies.[368] A "sacrifice" by a firm may be predatory if, through evidence, a plaintiff can show that conduct entails a sacrifice (loss) for the dominant firm, which the firm undertakes deliberately.[369] Sacrifice does not require any single cost benchmark. Rather, such a sacrifice occurs, according to the new EC Dominance Guidance paper, when a firm (a) charges a lower price for some portion or all of its output over the relevant time period at issue; or (b) expands its output over the relevant time period; or (c) such that it incurs avoidable losses.[370] The first cost benchmark that begins current EC analysis is average avoidable cost. The Commission's thought is that AAC is often the same as AVC (since it is the variable costs that can be avoided).[371] Pricing below AAC is therefore seen as sacrifice. The EU courts have yet to use the AAC benchmark.

EC case law supports the sacrifice approach currently undertaken by the Commission. The seminal case of *AKZO Chemie v. Commission,* involving chemical products, held: "A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its prices by taking advantage of its monopolistic position, since each sale generates a loss . . . ."[372] In *AKZO*, the pricing strategy undertaken by AKZO Chemie which required a sacrifice of profits, involved pricing at below the average total cost. The ECJ finds a sacrifice when (a) prices are below AVC; or (b) prices are below ATC but above AVC, and it is possible to prove that the firm has intended to eliminate competitors. A line of cases has further developed this approach. In *Tetra Pak II*,[373] a case involving the manufacture of aseptic and non-aseptic cartons, and in *France Télécom*,[374] a case

368. COMM'N OF EUR. CMTYS., *Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings* 20, http://ec.europa.eu/competition/antitrust/art82/guidance.pdf [hereinafter EUR. COMM'N].

369. *Id.*

370. *Id.* ¶ 63.

371. Note however that when AVC and ACC are dissimilar the Commission believes that ACC is a better indicator of avoided costs. *Id.* at 20 n.40.

372. Case C-62/86, AKZO Chemie v. Commission, 1991 E.C.R. I-3359.

373. Case C-333/94, Tetra Pak Int'l SA v. Comm'n of the Eur. Cmtys., 1996 E.C.R. I-05951.

374. Case C-202/07 P, France Telecom SA v. Comm'n of the Eur. Cmtys., 2007, *available at* http://curia.europa.eu.

involving the charging of below-cost prices for ADSL high-speed Internet services, the European Court of Justice held that the Commission could use two separate cost measures. In *France Télécom*, the court reaffirmed a lack of recoupment for institutional reasons.[375] The court reasoned that to demonstrate recoupment would increase the evidentiary burden upon plaintiffs.[376] This reasoning provides an opening that might allow for cases against SOEs to be successful, though it does not recognize that SOEs might never need recoupment in the first place.

France Télécom also discusses, however, that recoupment may be entertained where prices are below Average Total Cost (ATC) and above AVC.[377] In such circumstances, proof of recoupment may show eliminatory intent.[378] The Commission entertains predation claims between AVC and ATC because "[s]uch prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them."[379] This Commission belief in the importance of protecting less efficient competitors goes to the idea embodied in Article 82 of protecting the competitive process.[380]

The above cases all dealt with situations in which there was only a single product market. In *Deutsche Post AG*, the Commission examined different product markets in which it used Long Run Average Incremental Costs for those non-common fixed costs.[381] *Deutsche Post AG* is also the case most on point regarding predatory pricing. This case involved the European Commission's investigation of Deutsche Post AG ("DPAG") for abuse of a dominant position in Germany. At the time of the initial complaint against DPAG, DPAG was a one hundred percent SOE. The Commission found that because of the excess revenue produced from the reserve area, the reserve area could serve as a "likely and permanent source of

375. *Id.* ¶ 76.

376. *Id.*

377. *Id.* ¶ 14.

378. *Id.* ¶ 111.

379. *AKZO*, ECR I-3359, ¶ 72.

380. ALISON JONES, BRENDA SUFRIN & BRENDA SMITH, EC COMPETITION LAW 337 (3d ed. 2007).

381. Case COMP/35.141, Deustche Post AG, 2001 O.J. (L 125).

funding" for cross subsidization, because the revenues in the reserve sector exceeded the costs.[382]

The Commission held that between 1990 and 1995, DPAG's revenue was below its incremental cost of providing mail order parcel services. This allowed DPAG to successfully pursue predation. It did so through the cross subsidization of activities in the competitive sector by revenues from the reserve sector.[383] The Commission also discovered a longer lasting (1974-2000) anti-competitive fidelity rebate scheme.[384] The cross subsidization of DPAG enabled it to tie its fidelity program for mail parcel services, even though the parcel services was less efficient than its competitors.[385] The fidelity rebates prevented entry into the parcel services market by other firms through tying.[386] New entrants could not generate a critical mass necessary to sustain entry into the market.[387] This is an understanding of raising rival's costs even though it is not explicit.[388] Because of the lack of critical mass, it was not possible for mail order traders to set up an alternative delivery network infrastructure to that of DPAG.[389] The cost structure of the DPAG parcel services market was such that between 1990 and 1995, every DPAG sale presented a loss. In the medium term, this was not in the economic interest of DPAG. In the long term, continuing this line of business prevented entry by competitors.[390] The Commission fined DPAG $24 million and forbade any such conduct in the future.[391] It also imposed a structural remedy to separate DPAG's commercial parcel services

382. *Id.* ¶ 6. More recently, the Commission has suggested that cross-subsidies may be predatory, even in situations where the predator firm is not dominant in the predation market. ("The Commission may also pursue predatory practices by dominant undertakings on secondary markets on which they are not yet dominant. . . . While the dominant firm does not need to predate to protect its dominant position in the market protected by legal monopoly, it may use the profits gained in the monopoly market to cross-subsidize its activities in another market and thereby threaten to eliminate effective competition in that other market."). EUR. COMM'N, *supra* note 368, at 20 n.39.

383. Case COMP/35.141, Deustche Post AG, 2001 O.J. (L 125) ¶ 6.

384. DPAG had entered into standard form contract fidelity agreements in which firms had to entrust all mail order parcels to DPAG. *Id.* ¶ 34.

385. *Id.*

386. *Id.* ¶ 35.

387. *Id.* ¶ 37.

388. *Id.* ¶ 38.

389. *Id.*

390. *Id.* ¶ 42.

391. *Id.* ¶ 52–53.

from its reserved sector services.[392] Given that the cost of the penalty was less than the gains of anti-competitive conduct, it is unclear that this remedy created a chilling effect on anti-competitive behavior. Because the case did not need to get to particulars of what constituted a "cost" for purposes of LRAIC cost methodology, we lack an understanding on whether a different cost test would have been used for SOEs.

C. United Kingdom

Section 18 of the Competition Act 1998 lays out the test for an abuse of dominance under UK law.[393] Guidelines by the Office of Fair Trading ("OFT") provide a more detailed explanation of when pricing may be below cost.[394] The trend in the UK is, like in the EU, toward AAC, although AVC and AAC may be the same in a number of cases.[395] In *Cardiff Bus*, the Office of Fair Trade examined alleged predation by Cardiff Bus regarding starting a no frills bus service in response to a competitor on the same times and routes, running at a loss and then existing after the competitor exited the market.[396] The OFT found that the actions taken by Cardiff Bus abused a dominant position because of its exclusion, which did not allow for competition on the merits.[397] This was the first prohibition decision in five years, but the reasoning would not suggest a way to treat SOE predation, given the highly favorable and idiosyncratic facts in the case.

392. *Id.*

393. Competition Act, 1998, c. 2, §18, *available at* http://www.opsi.gov.uk/acts/acts1998/ukpga_19980041_en_1.

394. UNITED KINGDOM OFFICE OF FAIR TRADING, ASSESSMENT OF CONDUCT: DRAFT COMPETITION LAW GUIDELINE FOR CONSULTATION (Apr. 2004), http://www.oft.gov.uk/shared_oft/business_leaflets/competition_law/oft414a.pdf.

395. *See* UNITED KINGDOM OFFICE OF FAIR TRADING, DECISION NO. CA98/01/2008: ABUSE OF A DOMINANT POSITION BY CARDIFF BUS §§ 7.156–7.157, http://www.oft.gov.uk/shared_oft/ca98_public_register/decisions/cardiffbus.pdf ("In past cases these two bases have been shown to be very similar, since any cost that is variable over the period is also avoidable. Often the AAC benchmark will be the same as the AVC benchmark, because in many cases only variable costs can be avoided. However, where the dominant company makes specific investments, such as expanding capacity in order to predate, then the fixed or sunk investments made for this extra capacity will be included within AAC, causing AAC to exceed AVC.").

396. *Id.* §§ 1.1–1.4.

397. *Id.* §§ 1.1, 1.14.

Aberdeen Journals is one of the very few decisions using the abuse of dominance prohibition. It relies on the AVC test, although it provides some wiggle room. As the Competition Appeal Tribunal (CAT) noted, "[i]n our view, the cost-based rules set out in *AKZO* and *Tetra Pak II*, while providing guidance, are not an end in themselves and should not be applied mechanistically."[398] In *Aberdeen Journals*, the CAT analyzed what costs should be included within an AVC test as a price floor in a case involving predation by a newspaper and stated that recoupment was not necessary.[399] In some instances, the CAT found that pricing below AVC might be lawful if there is an objective justification for such pricing.[400] It also noted that prices above AVC but below ATC might be predatory assuming that pricing below ATC forces exit from the market of an equally efficient competitor.[401] The pricing issues in question in *Aberdeen Journals* went to questions of what was fixed versus variable but do not provide insights as to what is a cost in the case of a firm that has soft budget constraints.

D. South Africa

South Africa's abuse of dominance provisions can be found in Section 8(d)(iv) of the South African Competition Act 89 of 1998, specifically "selling goods or services below their marginal or average variable cost . . . ." In spite of a specific test in the statute, South African case law from the Competition Tribunal explains that other cost based tests may be used beyond that of MC and AVC.[402] The elements for a successful predation claim include a showing of dominance based on market share and market power that the goods or services are sold below MC or AVC and that efficiency defenses

398. ABERDEEN JOURNALS LTD & THE OFFICE OF FAIR TRADING, COMPETITION APPEAL TRIBUNAL, [2003] CAT 11, para. 380, http://www.catribunal.org.uk/files/JdgFinal2AJ230603.pdf.

399. *See id.* ¶ 358.

400. *Id.* ¶ 357.

401. *See id.* ¶ 445.

402. Nationwide Airlines and S. African Airways (92/IR/Oct00) ("[T]he complainant is not bound to follow the prescribed cost formula suggested in 8(d)(iv). In other words if a complainant, relying on section 8(c), can show that a respondents costs are below some other appropriate measure of costs not mentioned in the section it may prevail provided it adduces additional evidence of predation beyond mere evidence of costs. To determine what that should be we need to examine the phenomenon of predatory pricing and then examine some of the approaches taken in other jurisdictions.").

do not outweigh competitive harm.[403] The Commission has addressed frequent challenges recently against SOEs for unfair competition and abuse of their dominant market position. One case addresses predatory pricing by an SOE, *South Africa Airways*. In that case, the Competition Tribunal of South Africa ruled against the plaintiff based on an AVC test.[404] The Tribunal noted that it was open to the use of other tests. However, there was no explicit discussion of cost based tests for SOEs and whether it would be different for non-SOEs.

E. South Korea

There are two bases for a predatory pricing claim under Korean law, called the Monopoly Regulation and Fair Trade Act. Article 3-2 prohibits the abuse of dominant positions, and Article 23 of the Act that prohibits unfair business practices and applies to predatory pricing by non-dominant firms. Unlike other jurisdictions, Korea does not utilize a cost based test for predation. Rather, Korean predatory decisions focus on whether or not the alleged predatory pricing was "fair." According to Korea's predatory pricing test, price can be above average total cost and still be predatory. Intent is relevant, and there must be market foreclosure or consumer harm.

A series of examples of Korean case law provides a sense of what constitutes unfair competition. In the *Cadland* case, the Korea Fair Trade Commission ("KFTC") argued that Cadland purchased software from an American company but then bid at one won to provide Korean Electric with thousands of copies of this software (though the case does not specify the amount of the U.S. purchase, presumably it was at an amount greater than one won).[405] The KFTC argued that Cadland was willing to do this because once Korean Electric started using its software, Cadland would have locked in future business worth millions, making the contract essentially a long term deal.[406] Such underbidding conduct, according to the KFTC, constituted unfair and anti-competitive practice.[407] This line of reasoning holds for other Korean predatory pricing cases, such as

403. *See* South African Competition Act 89 of 1998 § 7.

404. *See* Nationwide Airlines and S. African Airways (92/IR/Oct00).

405. *See* KFTC v. Cadland Co., [1996] KFTC 96-18.

406. *Id*. The KFTC estimated that the winner of this bid would be guaranteed to get about 3 billion won, or about $2.2 million, worth of future business.

407. *Id*.

Samsung Tesco,[408] and predatory bidding cases such as *Ahnkook*, [409] *Lucky*,[410] and *Sangyong*. [411]

In *Samsung Tesco*, Samsung Tesco paid Coca Cola 984 won (approximately $0.73 per 1.5 liter) to distribute Coca Cola in its stores from August 30, 2000 through November 2, 2000.[412] However, Samsung Tesco sold Coca Cola below its cost at 390 won to 890 won (approximately $0.25 to $0.65) in order to attract more customers.[413] KFTC concluded that this was anti-competitive.[414] The case does not offer specifics as to whether or not there was some sort of short term price cutting defense that might have been part of some sort of loss leader promotion. A pro-competitive defense is possible under Korean predatory pricing law although the case does not mention if Samsung Tesco made such a defense.

The Korean Supreme Court ruled against predatory pricing in a claim that the KFTC brought in *Hyundai Information Technology Co.*[415] In *Hyundai*, the city of Incheon offered a contract for software with an estimated price of 972 million won (approximately $700,000).[416] Three companies bid.[417] Hyundai Information Technology Co. bid at 29 million won (approximately $21,000), Daewoo Information Systems Co. bid at 195 million won (about $141,000), and Samsung SDS bid at 330 million won (approximately $240,000).[418] Daewoo and Samsung complained to the KFTC and the KFTC intervened.[419] The parties litigated the case, and it went to the Korean Supreme Court,[420] which held for Hyundai.[421] It ruled that Hyundai's bid of 29 million won did not violate Korea's competition law because: 1) all other bidders bid

408. *See* KFTC v. Samsung Tesco Co., [2001] KFTC 2001-31.

409. *See* KFTC v. Ahnkook Co., [1994] KFTC 94-328.

410. *See* KFTC v. Lucky Brands Co., [1983] KFTC 83-12.

411. *See* Letter from KFTC to Sangyong Co., Case No. 9512.1241 (instructing Sangyong to cease and desist).

412. KFTC v. Samsung Tesco Co., [2001] KFTC 2001-31.

413. *Id.*

414. *Id.*

415. *See* Hyundai Info. Tech. Co. v. KFTC, [1999].

416. *Id.*

417. *Id.*

418. *Id.*

419. *Id.*

420. *Id.*

421. *Id.*

below the City's estimated price, and 2) the contract was for a software system that did not have any entrenched derivative benefits attached to it.[422] The second factor distinguished it from the fact pattern in *Cadland*.

F. Chile

Article 3°c of the Chilean Competition Act prohibits predatory practices.[423] So far, there has been only one predatory pricing case in Chile's antitrust jurisprudence, *James Hardie Fibrocementos Limitada*.[424] The Tribunal held with fixed assets that produced both products, each product was above AVC.[425] Moreover, there was no recoupment in another market.[426] On appeal, the Supreme Court reversed and held that James Hardie conducted predatory pricing in the first market by selling below ATC and then recouped its losses in the second market.[427] This case involved a private firm rather than an SOE.[428] The issue of what constituted a cost did not come up in terms of the analysis of either the Tribunal or the Supreme Court; they merely discussed the allocation of costs as to AVC.[429] Chilean case law is therefore silent on what outcome would be likely for a predatory firm with a soft budget constraint.

G. Canada

The Competition Act governs Canadian competition law.[430] Predatory pricing analysis is a sub-section of abuse of dominance, Section 79(1) of the Act.[431] Moreover, Article 50 provides for

422. *Id.*

423. Competition Law, art. 3°c, 2005, http://www.fne.cl/descargas/normativa/competition_law.zip (Chile).

424. *See generally* James Hardie Fibrocementos Limitada, sentence of the Supreme Court of Nov. 29, 2006; sentence of the Tribunal for the Def. of Competition of June 13, 2006.

425. *Id.*

426. *Id.*

427. *Id.*

428. *Id.*

429. *Id.*

430. Competition Act, R.S.C. ch. 34 (1985).

431. *See* Canada (Comm'r of Competition) v. Air Can., [2003] 26 C.P.R. 4th 476 (Comp.Trib.) (Can.); *see also* Canada (Dir. of Investigation and Research) v. Tele-Direct (Publ'ns), Inc., [1997], 73 C.P.R. 3d 1 (Can.).

penalties for unreasonably low prices under Section 50 of the Act.[432] In 2008, the Canadian Competition Bureau published its Predatory Pricing Enforcement Guidelines, which present state of the art thinking on Canadian predatory pricing policy.[433] The most recent Canadian predatory pricing case is *Air Canada*, which utilized an AAC test.[434] *Air Canada* marked a shift from the AVC test previously adopted under *R. v. Hoffmann La Roche Ltd*.[435] In *Air Canada*, the litigation focused on what constituted an avoidable cost for an airline route. For example, starting an unprofitable route might make economic sense because revenues might increase on other routes. This might add value to the network due to an increase in travelers. Whether to count such routes, called those "beyond contribution," as an avoidable cost would impact whether such conduct could be shown as predatory.[436] The Tribunal held that Air Canada had engaged in predatory pricing below AAC on two routes. However, the Commission ultimately dropped the case because of Air Canada's bankruptcy and other changes in Canada's airline sector. As the cost based tests all deal with private firms, it is unclear how soft budget constraints might be counted as costs. However, the Air Canada decision suggests that judicial administrability might have been a factor in how costs are to be calculated because of the fear that plaintiffs would be unable to carry out complex cost calculations.[437]

H. New Zealand

The generic prohibition against the abuse of dominance under the Commerce Act is in Section 36. There is only one case to date on predatory pricing, *Carter Holt Harvey Building Production Group*

432. *See* R. v. Hoffmann La Roche Ltd., [1980] 28 O.R.2d 164 (H.C.J.) *aff'd*, 33 O.R.2d 694 (Can.); R. v. Consumers Glass Co., [1981] 33 O.R.2d 228 (Can.).

433. Competition Enforcement Bureau, Predatory Pricing Enforcement Guidelines (2008), http://www.cb-bc.gc.ca/eic/site/cb-bc.nsf/vwapj/Predatory_Pricing_Guidelines-e.pdf/$file/Predatory_Pricing_Guidelines-e.pdf.

434. Edward Iacobucci, *Predatory Pricing, the Theory of the Firm and the Recoupment Test: An Examination of Recent Developments in Canadian Predatory Pricing Law*. 51 Antitrust Bull. 281 (2006) (providing in depth treatment of the case).

435. *Compare Hoffmann La Roche*, 28 O.R.2d at 164, *with Air Can*. 26 C.P.R.4th at 476.

436. *Air Can*. 26 C.P.R. 4th at 476, ¶ 301.

437. *See* Cyril Ritter, *Predatory Pricing Law in Canada, Australia and New Zealand: Recent Developments*, 2005 EUR. COMP. L. REV. 48, 52.

Ltd. v. CC.[438] The case involved differentiated products in the building insulation markets.[439] The case is not explicit as to the particular price test, though in investigations the New Zealand Competition Commission has used both AVC and AAC.[440] This case is analogous to one in Australia, to which New Zealand looked for guidance in its antitrust jurisprudence.[441] In the Australian case, *Boral Besser Masonry Ltd. v ACCC*, the court did not explicitly adopt a single price test.[442] There is no predatory pricing case specific to New Zealand SOEs. However, it is unlikely that it would be possible to win such a case in New Zealand as the Privy Council stated that recoupment is a requirement in a successful claim of predatory pricing.[443]

I. Sweden

Under Article 19 of the Swedish Competition Act, a firm may not abuse a dominant position. The Swedish Market Court, the highest Swedish Court in competition law cases, has decided one predatory pricing case. This was a case where a small competitor, BK Tåg, sued the Swedish state owned railways, Statens Järnvägar ("SJ").[444] The Market Court found that SJ had a dominant position in the Swedish market for operation of passenger traffic on railway and that SJ had committed a breach of Section 19 of the Swedish Competition Act in a bidding contest for operation of regional passenger traffic on railway.[445] In its analysis, the Market Court used the *Akzo* test.[446] The court found that SJ in its tender had priced below AVC.[447] The court also found that there was a presumption of

438. [2006] 1 N.Z.L.R. 145; [2004] 11 T.C.L.R. 200 (P.C.).

439. CC v Carter Holt Harvey Bldg. Prods. Ltd (2000) 9 TCLR 535, Supplementary Judgment of Professor Lattimore, para. 51 ("INZCO could recoup the cost of the Wool Line special pricing arrangement if the scheme meant that NWP was constrained from expanding in the market or eliminated from it. The recoupment would take the form of maintaining the list prices of Pink Batts at levels that were otherwise threatened by NWP, and at the same time increasing its market share for Pink Batts and other INZCO products.").

440. *See* N.Z. Commerce Comm'n, 2008 Unilateral Conduct Working Group Questionnaire submission to the ICN (on file with author).

441. *Id.*

442. [2003] 195 A.L.R. 609; [2003] 215 C.L.R. 374.

443. *Id.* at 469–70.

444. Marknadsdomstolen [MD] [Market Court] 2000-02-01 (Swed.).

445. *Id.*

446. *Id.*

447. *Id.*

exclusionary intent; a presumption SJ did not successfully rebut.[448] SJ's fine amounted to eight million Swedish crowns.[449] On one hand, the outcome of this test might signal that an SOE can be found guilty under an AVC test. However, a closer examination of competition policy in Sweden suggests all is not well regarding anti-competitive conduct by SOEs.

Specific to the area of competition in the postal sector, a report by the Swedish Postal and Telecom Agency suggested significant limitations for competition law to improve competition in the postal sector. Its report stated,

> The Swedish incumbent has been very active in defending its former monopoly and that is reflected in the many legal disputes. The Swedish Competition Act, which is the implementation of the EC rules on competition, does not appear to be well suited for a transition from monopoly to a market solution.[450]

The report suggested that the agency understands the weakness of the current antitrust jurisprudence regarding SOEs on predation issues, an area affected by this transition.

J. Japan

Two sets of provisions under the Japanese Act Concerning Prohibition of Private Monopolization and Maintenance of Fair Trade address predatory pricing. The first is the Article 3 prohibition against monopolization. The second is Article 19, which prohibits unfair trade practices. Section 6 of Article 19 proscribes predatory pricing. According to Section 6, "excessively below the cost incurred in the said supply" is interpreted as below AVC, and "a low consideration" is interpreted as below ATC.[451] Judicially, the AVC standard has been recognized in the private action *Daikoku*

448. *Id.*

449. Stefan P. Lindeborg & Tommy Pettersson, *Comments on a Swedish Case on Predatory Pricing—Particularly on Recoupment*, 22 EUR. COMPETITION L. REV. 75 (2001) (providing analysis of the case).

450. NAT'L POST AND TELECOM AGENCY, THE LIBERALISED SWEDISH POSTAL MARKET—THE SITUATION 14 YEARS AFTER THE ABOLITION OF THE MONOPOLY, Mar. 2, 2007, *available at* http://www.pts.se/upload/Documents/EN/Postal_liberalisation_2007_march 07.pdf.

451. DESIGNATION OF UNFAIR TRADE PRACTICES, (1982), *available at* http://www.cas.go.jp/jp/seisaku/hourei/data/utp.pdf.

decision[452] whereas the *Hamaguchi Petroleum* decision recognized above AVC but below the ATC test.[453]

A private suit, *Yamato v. Japan Post*, concerned predatory pricing by Japan Post.[454] Both the Tokyo District Court and Tokyo High Court rejected Yamato's claim made pursuant to Article 24. The Tokyo High Court rejected the assertion by the plaintiff that Japan Post's cost in commercial parcel delivery should be calculated on a "stand-alone" basis (separated from Japan Post's regulated postal delivery). The court opined that it is economically rational for an enterprise, when it enters into new business, to make use of its resources in its existing business. Separate from the case, the Japan Federal Trade Commission ("JFTC") published its opinion on the case as a study group report in 2006. The JFTC study group opinion was hostile to the position of Japan Post, advocating a "stand-alone" basis (at least regarding Japan Post pre-privatization) should be the method used to allocate common fixed costs when a monopolist in market A entered market B.[455] The Tokyo High Court in *Yamato* rejected the idea of a stand-alone basis because the stand-alone cost method was not mature as a legal test. As a general matter, the JFTC's regulatory standard on low pricing is that pricing below purchase price is illegal when it harms competition.[456] One problem in the *Yamato* case was a lack of evidence because the JFTC did not first bring a case of its own. Yamato could not obtain necessary cost data of the Japan Post to prove its sales-below-cost arguments. Therefore, it had to rely on unfair advantage, such as the tax exempt status the Japan Post enjoys relative to private companies.

There have been some other SOE predatory pricing cases in Japan. All of them were private suits. Nearly all of the decisions held for the defendants.[457] The only exception was the Tokyo District

452. Tokyo High Court decision, case no. 1413, 2002 (Ne), (Sept. 29, 2004).

453. JFTC remedy order, 53 SHINKETSUSHU 867–68 (May 16, 2006).

454. Tokyo High Court decision, case no. 1078, 2006 (Ne), LEXIS 28140088 (Nov. 28, 2007).

455. *See* JAPAN FAIR TRADE COMMISSION, ISSUES CONCERNING POSTAL SERVICES AND COMPETITION POLICY COINCIDING WITH THE ENACTMENT OF THE LAW OF THE PRIVATIZATION OF THE POSTAL SERVICES (2006), *available at* http://www.jftc.go.jp/e-page/pressreleases/ 2006/July/060721.pdf.

456. *See* JAPAN FAIR TRADE COMMISSION, GUIDELINES CONCERNING UNFAIR PRICE CUTTING UNDER THE ANTIMONOPOLY ACT 2–4 (Nov. 20, 1984), *translation available at* http://www.jftc.go.jp/e-page/legislation/ama/pricecutting.pdf (last visited Nov. 25, 2008).

457. *Postcard* case (Osaka High Court in 1994); *Bus for Aged Citizens* case (Yamaguchi District Court Shimonoseki Branch in 2006).

Court decision in the *Slaughterhouse* case.[458] The Supreme Court opined in that case that the Antimonopoly Act was applicable to low pricing by the Tokyo Municipal Slaughterhouse that cross-subsidized its sales. Nevertheless, the district court found the low pricing to be legal since the pricing did not harm fair competition.

VI. CONCLUSION AND RECOMMENDATIONS

SOEs remain an important part of economic life in many countries. This Article suggests that where SOEs face competition from other firms and where their advantages provided from the state are minimal, the corporate governance of such SOEs tends to be stronger than in situations in which SOEs face competition and behave as much as possible like private firms, such as in Sweden and New Zealand. SOE corporate governance seems to be better when there is more accountability. There is more accountability when SOE governance statutes reflect those of private firms. This result holds across legal origins. Indeed, some of the most un-competitive postal SOEs are in common law advanced economies such as Canada and the United States which tend to score highly in the LLSV literature. Antitrust solutions to SOE anti-competitive behavior seem to hold across jurisdictions regardless of legal origin. Predatory pricing jurisprudence does not distinguish between private and government firms even though the incentives may be different given the soft budget constraints of government firms.

The next stage in research in the area of competition and corporate governance of SOEs is to undertake a full cross country comparison and to do so across a number of different types of SOEs. This analysis would examine all cases and determine how the law in practice matches the law on the books for both corporate and antitrust laws. This is a significant task. The government oversight across SOEs varies both across and within countries. In some countries there are sector regulators or multiple regulators (sector, financial, etc.) to overview the SOEs. In other countries there is a general SOE law. With the creation of such a database, it would be possible to undertake cross country quantitative analysis to learn more about some dynamics of SOEs.

458. The Supreme Court: Tokyo Municipal Slaughter House decision Supreme Court decision, 43 (12) Minshu 2078, 2083 (Dec. 14, 1999).

Below are a number of recommendations that would improve competition and corporate governance regardless of the legal origin of SOEs.

A. Improved External Oversight

An annual performance review beyond annual reports may be necessary to encourage good corporate governance of SOEs. This would benchmark the SOE relative to other SOEs in the same sector in other countries and establish how well the corporation is meeting its target relative to similar entities elsewhere.[459] The benchmarking would include specific metrics to measure financial, management, and service aspects of the SOE relative to other SOEs.[460] Benchmarking across countries is made difficult by the various goals that SOEs might have in different countries.

Separate oversight functions for financial and management regulation across government agencies would reduce opportunities for regulatory capture. Other types of oversight include mandating accounting of SOEs by private auditing firms rather than by another part of government. This would reduce the possibility of government self dealing that might limit a full discovery of the condition of SOEs in auditing results. Part of an improvement in oversight would include an increase in effective penalties for poor oversight and management, particularly when SOEs engage in anti-competitive actions. There is a need for personal sanctions for bad behavior on the part of SOE managers such as the loss of job for SOE executives and barring work from other parts of government for a set time period after they are fired from SOE management. Another potential penalty would be for an SOE that is caught engaging in unlawful anti-competitive behavior or poor corporate governance to enter

459. *E.g.*, Maria Luisa Corton & Sanford V. Berg, *Benchmarking Central American Water Utilities*, 17 UTIL. POL'Y 267 (2009); Céline Nauges & Caroline van den Berg, *Economies of Density, Scale and Scope in the Water Supply and Sewerage Sector: A Study of Four Developing and Transition Economies*, 34 J. REG. ECON. 144 (2008).

460. *See* Antonio Estache, Serigio Perelman & Lourdes Trujillo, *Infrastructure Performance and Reform in Developing and Transition Economies: Evidence from a Survey of Productivity Measures* (World Bank Policy Research, Working Paper No. 3514, 2005) (providing a framework for benchmarking); Céline Nauges & Caroline van den Berg, *Economies of Density, Scale and Scope in the Water Supply and Sewerage Sector: A Study of Four Developing and Transition Economies*, 34 J. REG. ECON. 144 (2008) (using panel data for cross country benchmarking).

into a process of structural separation between the statutory monopoly business and the competitive business.[461]

Another possibility is to forbid the SOE to compete in the non-regulated related field. The potential problem with such an outcome, at least in the postal sector, is that the postal SOE will be unable to use its economies of scope to offer products and services in related markets. The advantage of utilizing the economies of scope would be that such economies keep the price down for a number of goods and services that are basic to the regulated part of the business. Another way to think about structural separation would be to ensure that SOEs separate the profit-making and non profit-making goals into separate firms. Codes of conduct should be established and enforced between regulated and unregulated entities. Where SOEs could compete based on efficiency concerns, they should not be allowed to potentially utilize funds from non-profit making functions in anti-competitive ways.

Another method of external oversight is through the capital markets. Governments should make SOEs go to capital market for loans. This will encourage SOEs to be disciplined to pay back the loans, so long as there are no soft budget constraints. If governments implicitly guarantee loans, this solution is not viable because the worse the governance of the firm, the better the rate, because the government is more likely to guarantee repayment of the loans.

B. Improve Internal Corporate Governance

It is important to improve the quality of internal corporate governance of SOEs. The corporate social responsibility movement and the shareholder democracy movement have been issues of significant attention in both academic and policy circles.[462] If we are to take the corporate social responsibility movement seriously, it is particularly necessary to do so with regard to SOEs. Governance is more opaque and less responsive to shareholders of SOEs than of publicly traded firms. This would entail greater penalties for a fiduciary breach on the part of the SOE board. This should include

461. *But see* MARK A. JAMISON & JAMES SICHTER, PUBLIC UTILITY RESEARCH CTR., BUSINESS SEPARATION IN TELECOMMUNICATIONS: LESSONS FROM THE U.S. EXPERIENCE (2008), http://ssrn.com/abstract=1384582 (noting the difficulties of separation in the U.S. telecom context).

462. *See, e.g.*, Michael Siebecker, *Trust & Transparency: Producing Efficient Corporate Disclosure Through Fiduciary-Based Discourse*, 87 WASH. U. L.R. (forthcoming 2009).

steep financial penalties for managers and directors that breach their duties. Governments should strive to increase the use of non-governmental appointed directors on the board of SOEs. The state should reduce the number of political appointments on SOE boards and increase the number of directors who have previous business experience that would be useful in running a company. There might be some informal norms such as shaming that might improve corporate governance. For shaming sanctions to be successful, there needs to be enough transparency for information about bad corporate governance of SOEs to emerge and a sense in a given country that the lack of accountability is something for which one should be ashamed.

A problem that SOEs face more than private firms is soft targets for performance. Whereas performance contracts might work for private firms, the incentives are different for public firms and therefore performance contracts are not as successful. Because of the asymmetry of information between managers and shareholders (or in the case of SOEs, the government officials acting on the public's behalf), management will try to create performance contracts based on easily achievable targets. However, what separates performance contracts in private and state firms is that private firms can reduce the problem of soft targets and information asymmetry by creating stock options and by using benchmarking for performance to better align management interests with those of shareholders.

C. Corporatization of SOEs

Some countries have shifted the nature of SOE governance to a more corporatized form of governance. In postal delivery, most EU countries' postal operators have a corporatized form.[463] SOE management and directors may be mandated to have specific skills and/or experience.[464] Creating a competency profile provides a set of standards by which government can require effective managers. Policy targets, including financial goals, would create quantifiable targets for the SOE to meet. The failure to meet such targets could lead to the ouster of SOE leadership. This process would better align

463. WIK CONSULT, STUDY FOR THE EUROPEAN COMMISSION, MAIN DEVELOPMENTS IN THE POSTAL SECTOR (2004–2006) 3 (2006), http://ec.europa.eu/internal_market/post/doc/studies/2006-wik-final_en.pdf.

464. Scott, *supra* note 70, at 4.

management's interest with residual owners' because management would have an incentive to create a more efficient SOE.

Corporatization has proven to be an intermediate step for SOEs that reduces some incentives for mismanagement due to soft budget constraints and a lack of internal and external accountability by making the SOE act more like a private firm.[465] Corporatization forces firms to ask if there are better ways to achieve lower costs. If an SOE is in a corporatized form, it is easier to keep track of the performance because of better and more information. Some empirical work supports the proposition that corporatization can improve the efficiency of SOEs.[466] In most cases, this is a second best solution. If there are strong concerns about managerial incentives of SOEs, corporatization is not equivalent to privatization.[467] However, if privatization is not possible politically, corporatization may be a second best solution or an intermediary step to privatization, such as in New Zealand for the New Zealand Post.

Where SOE postal incumbents have been commercialized and corporatized, SOEs behave more like private companies. Generally, this has been successful and not surprisingly, it is successful in precisely those countries that provide for greater competition.[468] Thus, competition and good corporate governance indeed seem to be somewhat substitutable. A successful commercialization provides an example of how to limit some of the impulse of an SOE postal incumbent to raise the cost of rivals.

Let us examine the case of New Zealand. Prior to its transformation, New Zealand Post had a statutory monopoly with its large reserve sector based on parcels with a weight of less than 500g.

465. José A. Gómez-Ibáñez, *Alternatives to Infrastructure Privatization Revisited: Public Enterprise Reform from the 1960s to the 1980s*, at 25–27 (World Bank Policy Research, Working Paper No. 4391, 2007).

466. Varouj A. Aivazian, Ying Ge & Jiaping Qiu, *Can Corporatization Improve the Performance of State-Owned Enterprises Even Without Privatization?*, 11 J. CORP. FIN. 791 (2005) (analyzing corporatized Chinese SOE performance).

467. Shleifer, *supra* note 67, at 137–38 (claiming that private ownership is superior to government ownership because private ownership creates incentives to reduce costs while government officials have incentives to supply monopoly rents); *see* Besley & Ghatak, *supra* note 68 (arguing that government ownership should be limited only in situations where the SOE project creates primarily public goods and the government values those goods more than anyone else).

468. Michael A. Crew & Paul R. Kleindorfer, *Developing Policies for the Future of the United States Postal Service*, *in* COMPETITIVE TRANSFORMATION OF THE POSTAL AND DELIVERY SECTOR (Michael A. Crew & Paul R. Kleindorfer eds., 2003).

On April 1, 1998, New Zealand removed the statutory monopoly on all letters, regardless of weight. New Zealand Post was given, for the most part, equal treatment with all other postal operators including full application of competition laws. By the end of the year, there were seventeen registered postal operators within New Zealand. The majority of these competitors were small local businesses. Corporatization of the SOE in New Zealand between 1987 and 1998 increased transparency and accountability of New Zealand Post. Staff became more productive (a staff decrease of 40%, fewer handles, and an increase of business of 20%), New Zealand Post more profitable (a $NZ37.9 million loss became a profit of $NZ47.7 million), prices lower (the basic letter price was at the same nominal price in 1987 and 1998), and service delivery quality improved.[469] New Zealand closed a third of the country's post offices. This led to remarkable results: 100% increase in labor productivity, 30% increase in mail volume and a 30% decrease in both the real price of postage and of costs. These changes all occurred while maintaining state ownership of New Zealand Post.[470] One can tell a similar story in Sweden. The loss of the postal monopoly in Sweden was a significant reason that Posten become more efficient and eliminated many redundant post offices and centers even while maintaining its universal service mission.[471]

Corporatization is not an end solution. Even if the goals of private and public firms were the same, the behavioral outcome of such firms would be different. As Alchian explains, "[E]ven with the same explicit organizational goals [between public and private firms], the cost-rewards system impinging on the employers and the 'owners' of the organization are different."[472] Not surprisingly, therefore, some corporatized SOEs do very poorly, even those in common law jurisdictions. Both USPS and Canada Post are

469. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, PROMOTING COMPETITION IN THE POSTAL SECTOR, DAFFE/CLP(99)22, 247–52.

470. FEDERAL TRADE COMMISSION, *supra* note 288, at 79.

471. It is possible that contestable markets theory might apply in the liberalized postal sector. *See generally* WILLIAM J. BAUMOL, JOHN C. PANZAR & ROBERT D. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982). Contestable market theory is based on a number of assumptions and may not hold outside of these assumptions. *See, e.g.*, Fabio Domanico, *The European Airline Industry: Law and Economics of Low Cost Carriers*, 23 EUR. J.L. & ECON. 199 (2007); Joseph Farrell, *Cheap Talk, Coordination, and Entry*, 18 RAND J. ECON. 34 (1987).

472. Alchian, *supra* note 77, at 817–18.

corporatized but both maintain a significant reserve sector. Perhaps the better lesson about corporatization is the more an SOE actually looks corporatized, with director control rather than government control, and the more competition it faces to ensure that corporatization actually matters, the more SOE outcomes may reflect those of private firms.

D. Increase Competition

Competition means the elimination or at the very least a significant reduction of the reserve sector, such as what the EU has undertaken. It also means a limit upon incumbent firms to abuse the universal services requirement for anticompetitive purposes. As noted earlier in this Article, liberalization creates competitive pressure that will eliminate poor governance from firms. Liberalization is politically difficult.[473] This is especially true in the current period of world-wide economic crisis. The rhetoric of liberalization has not matched the reality of liberalization, where in fact some liberalization efforts are merely a different and perhaps only somewhat less restrictive form of regulation. However, when these half hearted liberalization schemes fail, there may be significant public resentment and then pushback against liberalization.[474] Even in the developing world, postal competition has proved sustainable. One example is Tanzania where total mail volume since liberalization increased from 0.87 letters per capita per year to 1.2 per capita per year.[475]

Competition may have other effects. It might create a bypass for certain parts of an industry by alternative means. For example, the internet has changed the way in which people send messages to each other. This has made the mail system susceptible to a death spiral in which the high end customers leave the system and firms raise costs to make up for these departures, thereby leading to more departures.

E. Privatization

Privatization eliminates the soft budget constraint because firms have to rely upon the market, which creates a level of financial

473. *See, e.g.*, Edward Iacobucci, Michael Trebilcock & Ralph A. Winter, *The Canadian Experience with Deregulation*, 56 U. TORONTO L.J. 1 (2006).

474. Fox, *supra* note 296, at 216–17.

475. Kenny, *supra* note 142, at 77.

discipline.[476] One legislative response to the problem of SOEs has been to privatize these enterprises.[477] During the 1980s and 1990s, countries privatized over 100,000 firms around the world, particularly in Latin America, East Asia, and the former Soviet block.[478] SOEs are less efficient than private firms. Therefore the overall performance of SOEs vis-à-vis private firms compares poorly.[479] Where privatization has not led to greater efficiencies, in many cases, it has been a result of the failure of the architects to introduce liberalization in conjunction with privatization. Put differently, when privatization fails, it seems to be because of flawed design and implementation.[480] That is, there are potential risks to privatization when there are situations of market failure and where there is inadequate regulation to protect the market function. Empirical work in Russia suggests that privatization without adequate regulation can lead to corporate looting.[481] Similarly, Carlos Slim became the world's richest man because he bought the telecom incumbent in Mexico when it was privatized and allowed to maintain its statutory monopoly in fixed line telephony.[482]

A difficult situation may emerge where, if there is no privatization and liberalization in the near term, the yearly government bailout will create an even bigger problem in the long term. At that time, the effect of trying to create cost controls on

476. *See* Emmanuelle Auriol & Pierre M. Picard, *Infrastructure and Public Utilities Privatization in Developing Countries*, 23 WORLD BANK ECON. REV. 77, 80 (2009) (providing a literature review).

477. In many cases, successful liberalization has proceeded with efforts at privatization of SOEs. John Nellis & Nancy Birdsall, *Privatization Reality Check: Distributional Effects in Developing Countries, in* REALITY CHECK: THE DISTRIBUTIONAL IMPACT OF PRIVATIZATION IN DEVELOPING COUNTRIES 12 (John Nellis & Nancy Birdsall eds., 2005). These findings support earlier empirical studies suggesting that privatized firms outperformed SOEs and increased their efficiency. *See* Megginson, Nash & van Randenborgh, *supra* note 31, at 405; Shleifer, *supra* note 67, at 134–41.

478. Nellis & Birdsall, *supra* note 477, at 3, 11–12 (arguing that those privatizations that were pro-competitive addressed the equity concerns regarding the distribution of the benefits of privatization).

479. Simeon Djankov & Peter Murrell, *Enterprise Restructuring in Transition: A Quantitative Survey*, 40 J. ECON. LIT. 739 (2002) (studying the effects of privatization).

480. Harry M. Trebing & Sarah P. Voll, *Infrastructure Deregulation and Privatization in Industrialized and Emerging Economies*, 40 J. ECON. ISSUES 307, 311 (2006).

481. Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. PA. L. REV. 2131, 2133 (2001).

482. *See* D. Daniel Sokol, *Barriers to Entry in Mexican Telecommunications: Problems and Solutions*, 27 BROOK. J. INT'L L. 1 (2001).

SOEs may come at a higher cost. Addressing this situation means overcoming significant public choice problems not merely from SOEs but from vested private interests that benefit from the status quo. Though competition advocacy on the part of antitrust agencies may help, competition advocacy has its limits as agencies are subject to political retribution from legislators who might not want a pro-competitive message.[483] For example, while the FTC has had a strong advocacy program,[484] it has never questioned why there should be a state action exemption, nor did it discuss, in the postal context, the possibility of privatization of the USPS.

F. Create an Effective Antitrust Test

One problem with antitrust approaches to predatory pricing cost-based tests is that they do not account for the government-created distortion in creating a revised baseline for how to measure a cost.[485] One conclusion from the cross-country analysis is that antitrust has been ineffective, across legal origins, in accounting for the nature of SOEs in cost-based tests to determine predatory pricing. Incremental cost tests may not detect potentially anti-competitive behavior by SOEs. As Panzar suggests, "Because a revenue maximizing SOE wishes to offer below cost prices on a continuing basis, it may find it optimal to alter its strategic investment policies so as to distort the outcome of any incremental cost test to which its rates may be subject."[486] However, current predatory pricing tests do not account for this difference.

This Article suggests that antitrust predatory pricing tests require an imputation of the various costs and benefits of government ownership and government support of SOEs. This test would measure the various indirect benefits that SOE providers receive from their governments in terms of assessing the cost floor. Part of the reason for the lack of the use of such a test may be that, in practice, an SOE often incurs both advantages and disadvantages from its state-owned status, and some of these disadvantages (e.g., loss of managerial control) may be difficult to quantify.

483. D. Daniel Sokol, *Limiting Anti-Competitive Government Interventions That Benefit Special Interests*, GEO. MASON L. REV. (forthcoming 2009).

484. *See* James C. Cooper, Paul A. Pautler & Todd J. Zywicki, *Theory and Practice of Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091 (2005).

485. Sappington & Sidak, *supra* note 153, at 518.

486. Panzar, *supra* note 297, at 21.

Administrative ease is certainly an important practical concern. Some rough rules of thumb might be proposed on these grounds. The most appropriate rule of thumb (and rule generally) will depend upon the relevant social objective. Is it clear what this objective should be? If the social objective is efficiency through the use of antitrust law, then the contours of such a test might be based on an imputation test for SOEs.

One imprecise analogy would be to cost imputation in TELRIC pricing in telecommunications. The cost imputation of TELRIC pricing of the 1996 Telecom Act seems to have been unadministrable for quite some time in the United States, New Zealand, and other jurisdictions. However, there are also differences between SOE cost imputation and TELRIC cost imputation. TELRIC methodology was adopted primarily because of the issue of selling inputs to retail competitors. This issue, and thus the TELRIC methodology, may be less germane in many relevant settings. While TELRIC served primarily to keep the incumbent's (wholesale) prices relatively low, pricing restrictions for SOEs may serve primarily to keep the incumbent SOE's (retail) prices relatively high.

Many antitrust systems are concerned with the potential of false positives in prosecution.[487] This is particularly a concern in predatory pricing cases when low prices may support competition even if they harm competitors. Compounding the issue of what might go into an SOE predatory pricing test is the concern that courts may not be able to handle such complexity. That is, legal rules must be administrable. As Hovenkamp notes:

> [T]here is relatively little disagreement about the basic proposition that often our general judicial system is not competent to apply the economic theory necessary for identifying strategic behavior as anticompetitive. This makes the development of simple antitrust rules critical. Antitrust decision making cannot consider every complexity that the market presents.[488]

Accordingly, it is better to have an easier-to-administer test of predation for SOEs than a complex test if the error cost for the

487. Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 2–3 (1984) (discussing the greater harms of false positives over false negatives).

488. HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 47 (2005).

complex test would be too high.[489] Administrability is particularly a concern regarding a predatory pricing test that would treat one form of entity differently than another and would require a complex imputation test.

What is not clear is whether or not a separate SOE predatory pricing test is administrable in either common law or civil law jurisdictions. Such a test would require a sense of the costs of an efficient entrant. To determine this cost, there would need to be a way to determine what costs are due to the soft budget constraint of the SOE based on its governance structure and the special privileges that the government grants it. Based on the general concern of administrability of predatory pricing, it is not clear that such a specific test—if it could be devised—might be understood and administered by courts. Antitrust case law would need to catch up to economic thinking on SOEs and on government support for firms. Courts across the countries surveyed have yet to be able to show an ability to grapple with these issues effectively and seem to have some trouble even with cost-based tests involving private firms. An antitrust solution needs more work both at the theoretical level and in terms of implementation within antitrust doctrine.

The purpose behind much of antitrust analysis is to determine what an efficient competitor would do. However, in the case of SOEs, the problem is that an efficient new entrant would never have created the type of network that many SOEs have. European state aids jurisprudence recognizes this point but most countries lack a state aids regime.[490]

G. Final Thoughts

Overall, SOE competition and governance issues are difficult questions. Unfortunately, the prospects for a simple, neat rule for SOE pricing seem limited. Competition law is inadequate at present given a lack of an effective test to measure predation by SOEs as well as administrability problems. A larger competition policy may or may not be inadequate—privatization is clearly not palatable and competition advocacy to liberalize markets may be a non-starter during the current global crisis. Public choice concerns limit regulatory liberalization and these concerns must be overcome.

489. On error costs, *see* Easterbrook, *supra* note 487.

490. Chronopost SA v. UFEX, C-341/06 P and C-342/06 P, ¶ 38 (Dec. 6. 2007).

Some SOEs matter more than others, particularly those in critical network industries (e.g., transport, finance, utilities). In these areas sector regulators have serious capture problems. Perhaps the world-wide macro-economic crisis leading to a reinvigorated IMF that demands liberalization might be the only way to create more competition. Better corporate governance, akin to the requirements of corporate governance for publicly traded firms, might help. A key role of price floors for SOEs is to limit "empire building" by SOE managers. Perhaps empire building can be limited more effectively in practice via internal governance reform; the ideal rules for SOE pricing may well be sector-specific.[491] These are themes worth developing in future scholarship.

491. Mark Armstrong & David E.M. Sappington, *Regulation, Competition, and Liberalization*, 44 J. ECON. LIT. 325, 326 (2006) ("[T]here is no single set of directions that can guide the challenging journey from monopoly to competition in all settings.").