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Rethinking the Foreign Direct Investment Process in Post Conflict Transition Countries

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RETHINKING THE FOREIGN DIRECT INVESTMENT PROCESS AND INCENTIVES IN POST CONFLICT TRANSITION COUNTRIES

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Just as a farmer tills the land, plants and nurtures the crops for a great harvest, so must the State take measures for the development of its economy.

ABSTRACT

Burdened by the remnants of conflict, continuing threats of security lapses, significant market failures and weak institutions, post conflict transition countries can hardly be described as normal economies. The task of transforming them into vibrant, productive and self-sustaining economies is no simple assignment. Constructing the blueprint for reconstruction and economic development requires creativity of the first order. Conventional theories or pure neo-liberal market driven policy levers preached by the Washington Consensus group are not likely to be productive. The design of the investment regime for development should therefore focus on non conventional policy constructs. Contrary to the received theories, the history and evidence of conventional foreign direct investment (FDI) as an engine of growth and development in developing countries has been disappointing. It is doubtful whether such FDI can play the necessary transformative role in countries facing more extraordinary economic and political conditions than other developing countries. What post conflict transition countries need for their transformation is an industrial strategic policy architecture that emphasizes domestic value added high value investment demand targeting specific sectors and projects. Non conventional FDI policies should then play a complementary role to the domestic investment demand for

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economic development. One type of non conventional FDI that can play a meaningful role in post conflict transition countries is the project finance model that incorporates irreversible high value build operate and transfer (BOT) or similar operations with the potential for the greatest development impact. The BOT will be supported by a Post Conflict Guarantee Fund and operated by sponsors for a limited time period. Any necessary FDI incentives can then be constructed and directed at actual impediments to achieving the specific developmental objectives of each country.

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I. INTRODUCTION

Prominent among the many challenges facing post conflict transition countries is how to design and implement the blueprint or strategic architecture for transforming their economies into vibrant productive and self-sustaining economies. Shattered by conflict or deprived of skilled labor and capital from brain drain and capital flight, post conflict economies are seldom normal economies. Laboring under the weight of severe security problems and significant market failures, they tend to be underperforming economies characterized by rent seeking, bureaucratic and elite groups capture. In this context, we must start with the notion that post conflict transition countries are in the second-best world. They suffer from many constraints and distortions, particularly those relating to investments. In many of these countries there might be weak financial institutions, poor access to capital or low investment demand, either as a result of unattractive private appropriability, or low social returns on investment. Investments might also be suppressed by the wrong perceptions of market size that can support economies of scale. If weak institutions hamper entrepreneurial investments in developing countries, and are the root causes of underdevelopment, the conditions of weak institutions in transition countries will be magnified at least three fold. Consequently, transforming these economies is no ordinary task. As one U.N. institution has put it, “extraordinary creativity in policy design” and implementation is necessary. Conventional policy levers are most likely ill suited to the task. It is in this light we approach the issue of the role of foreign direct investment (FDI) in the transformation of post conflict transition countries.

At the outset, it must be stressed that post conflict transition countries come in different forms. At one end of the spectrum are failed states such as Liberia, Sierra Leone, Somalia, Democratic Republic of Congo and Bosnia-Herzegovina that are recovering from collapse and are on the path to some level of security, stability, and legitimacy. At the other end of the spectrum are countries that

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emerged from conflict with their political and other institutions relatively in tact. This category of states includes Guatemala, Sri Lanka and the former Yugoslav Republic. There is yet a third category of post conflict transition countries, such as Rwanda, that have managed to reconstruct the essential institutions for transformation and have embarked on what appears to be an irreversible path towards development. The last category of post conflict transition countries did not experience an outbreak of violence that completely destroyed the state, but nevertheless continue to experience sufficient levels of periodic violence to put them in the same category as the others. It is this assemblage of states for which the question is posed as to the role of FDI in their economic development and the extent to which incentives for FDI might be relevant.

The answers to these questions demand a broader framing of the issues. FDI is only a sub-category of the investment regime required to transform these countries. Experience has shown that FDI flows to the least developed countries are insignificant in comparison to other regions of the world. Moreover, as appropriately pointed out by a World Bank study and the experience of recent development success stories, development requires two types of complementary investments: public and private. So, the critical question is what are the investment needs of post conflict transition countries if their economies are to be transformed into vibrant systems within the larger global economy? The issue is framed more broadly to draw attention to certain misconceptions about FDI and development.

What is important about FDI is its perceived beneficial impact on development. It is often assumed that FDI will spur growth and induce the transfer of technology and much needed know-how to the host country. This perceived role gained greater credibility with the outstanding economic performance of the Asian Newly Industrializing Countries (NICs) such as Taiwan, South Korea, Singapore, Hong Kong and Malaysia. The emergence of China and India as major economies on the rise has further given greater prominence to the beneficial impact of FDI on development. However, the complexity of the underlying reasons for the success of the Asian NICs does not permit any isolated categorical statement about the impact of FDI on their development. Recent studies point to a host of complex mixtures of

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6 Justin Yifu Lin, Fang Cai, Zhou Li, The China Miracle: Development Strategy and Economic Reform (1996)(discussing the strategy employed for China’s leap forward in economic reforms and the results of such reform);
macroeconomic and government market interventions as significant contributing factors.\(^7\)

Notwithstanding the multiplicity of contributing factors, the general perceptions and assumed beneficial effects of FDI mask the complexity of FDI and its role in economic development. Since the decades of the 1970s and 1980s, various studies have questioned the claims of FDI’s positive impact on development.\(^8\) The studies showed that the impact of FDI on development is not always unambiguously positive. In other words, any benefits that accrue from FDI may depend critically on the absorptive capacity of the host country, the nature of the internal linkages created with the local economy, the quality (high value) of the investment and, to a large extent, the role of the host government in channeling or guiding the process toward specific developmental goals.\(^9\) Other studies challenged the efficacy of tax and other fiscal incentives for attracting FDI. Indeed, one of these studies questioned the theoretical foundations of tax incentive policies and concluded that not only were tax and other fiscal incentives ineffective instruments for attracting FDI, but they also provided a form of perverse reverse subsidy from impoverished and weak recipient states to affluent capital exporting countries.\(^10\) This irony of the poor subsidizing the wealthy through their incentives for FDI should not be lost on policy makers confronted with the difficult task of designing programs for transforming weak and impoverished post conflict states laboring under severe resource constraints.

Over two decades later, the United Nations Conference on Trade and Development (UNCTAD) in a most revealing study on FDI in Sub Saharan Africa (SSA), not only questioned the perceived beneficial impact of FDI in the region but also expressed serious skepticism about the utility of conventional

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\(^7\) John Page, The East Asian Miracle: Four Lessons for Development Policy, NBER MACROECONOMICS ANNUAL, 1994 at 219; Dani Rodrik, Getting Interventions Right: How South Korea and Taiwan Grew Rich, ECONOMIC POLICY, APRIL (1995)(explaining the complexities of the policy mix used by South Korea and Taiwan for achieving development and riches); York W. Bradshaw, Young-leong Kim, Bruce London, Transnational Economic Linkages, the State and Dependent Development in South Korea, 1966-1988: A Time-Series Analysis, 72 SOCIAL FORECES 315 (1993)(hereafter Bradshaw, Kim & London, State and Dependent Development in South Korea)(explaining the direct involvement of the State in development relying heavily on international trade); Alwyn Yound, The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience, QUARTERLY J. ECON. AUGUST (1995)(examining the role of factor accumulation in the extraordinary post war growth of Hong Kong, Singapore, South Korea and Taiwan).


\(^9\) Id. at 99; John H. Dunning, Re-Evaluating the Benefits of Foreign Direct Investment, 3 TRANSNATIONAL COPR. 23, 32-33 (1994).

thinking on the subject in that region. We have had occasion to comment briefly that although the recommendations of the study were in the right direction, they were not bold enough. However, because many of the post conflict transition countries are within Sub Saharan Africa, and the call by UNCTAD for rethinking FDI has wider implications beyond SSA, it will be useful to examine some of its core arguments. The following observations deserve particular attention.

First, the UNCTAD study found that the SSA region is lagging behind others in terms of the size, performance and beneficial impact of FDI. Second, contrary to familiar arguments, the unattractiveness of SSA and the poor developmental impact of FDI in the region cannot easily be attributed solely to the failure of market-oriented governance reforms. Third, FDI carries with it costs and benefits which must be critically assessed by policy makers if host countries are to capture some of the hoped-for positive contributions to their economic development objectives. Fourth, since the colonial era, Africa has been the victim of FDI-led enclave economies, described elsewhere as scoop and ship operations, particularly in the mining sector. Extractive institutions which were established during the colonial era have continued to burden African economies as constraints to development. It is therefore hardly surprising that the UNCTAD study correctly observed that any lack of sensitivity to this enclave phenomenon in FDI policy design will entrench a relationship that has been least beneficial to the continent. Fifth, it also pointed out a major fallacy in current thinking that greater openness and downsizing of the state will attract FDI. Not only has this proved to be empirically false, but it also has the effect of distracting policy makers from focusing on the fundamental determinants, drivers or theories of FDI and growth. Sixth, following the steps of earlier studies critical of incentives as instruments for FDI, the study concluded that tax and other fiscal incentives might produce the perverse effect of subsidizing the rich capital exporting countries, even as the benefits to poor host countries are highly questionable. Finally, the study stressed that an FDI policy cannot be justified

12 Kojo Yelpaala, In Search of a Model Investment Law for Africa, in 1 AFRICAN DEVELOPMENT BANK LAW FOR DEVELOPMENT REVIEW 2, 74-75 (Seward M. Cooper et al. eds., 2006) [hereinafter Yelpaala, Model Investment Law].
13 UNCTAD, RETHINKING FDI, supra note 11 at 4-5.
14 Id. at 2.
15 Id.
16 Yelpaala, Model Investment Law, supra note 12, at 12. “Scoop and ship” refers to “operations in which the resources of the host country are extracted, loaded onto ships and exported for processing in other countries.” Id.
17 Daron Acemoglu, Simon Johnson, James A. Robinson, The Colonial Origins of Comparative Development: An Empirical Investigation, 91 AMER. ECON. REV. 1369, 1376 (2001) (arguing that extractive institutions were necessitated by the inhospitable environment for settlement but the extractive institutions survived independence of the colonies).
18 UNCTAD, RETHINKING FDI, supra note 11, at 35-36.
19 Id. at 2-3; Yelpaala, Efficacy of Tax Incentives, supra note 10, at 388, 392. 
merely because it provides the highest returns to FDI. Rather, FDI can only be justified if it is high value and contributes significantly to technological spill-over effects or jobs. Otherwise, FDI might keep the host country in a low-level development trap.\(^{20}\)

One of the inescapable lessons from the numerous studies of FDI’s impact on development, is that left to its own devices FDI is unlikely to generate growth, lead to meaningful technology transfer or create the internal links necessary for the development of certain regions of the world. In view of this, it is highly questionable whether the policy framework for transforming post conflict transition countries can have reliance on FDI as its central focus. Indeed, as will be shown below, a brief review of the characteristic attributes and distinctive behavior of foreign investors suggests that such reliance would likely be unproductive.

The rest of this Article is divided into the following parts. In Parts II and III we examine the patterns and basic characteristics of FDI in general and with particular reference to post conflict transition countries. Parts IV and V are devoted to a systems analysis of the MNE and the implications of that system to the development objectives of post conflict transition countries. Part VI is focuses on an analysis of the essential characteristics of an industrial policy architecture for transforming post conflict transitions countries and the role of the “developmental State” in that process. Part VII reconfigures the purpose of project finance for developing privately managed industrial projects with the greatest developmental impact. In Part VIII, we explore the use of the Build Operate and Transfer (BOT) model within the context of industrial project finance for developing local enterprises and an entrepreneurial class. BOTs are generally characterized by several risks and Part IX addresses some of those key risks. Given the novel approach to the use of non-conventional foreign investment advocated in this Article, in Part X we explore what role incentives might play in achieving the developmental objectives of host countries. Part XI is devoted to some concluding remarks and thoughts.

II. PATTERNS IN GLOBAL FDI

In order to contemplate the role of FDI in the policy framework for transforming post conflict transition countries, it is important to start with some understanding of the basic characteristics, patterns and distinctive behavior of FDI. It is essential for policy makers to determine how and where post conflict transition countries fit into the strategic vision of foreign investors whose new conception of economic space and economic geography spans the entire globe without regard to national borders. A policy framework that does not take into account where and how these countries fit into the recurrent mind-set of foreign investors is likely to yield minimal beneficial results and might even be detrimental to the developmental objectives of the host country.

\(^{20}\) UNCTAD, RETHINKING FDI, supra note 11, at 36.
While the FDI phenomenon is becoming increasingly complex, there are certain basic patterns which seem to characterize globally the flow of foreign direct investment. First, several studies indicate that FDI tends to be highly concentrated by region, by country, and by industry. For example, FDI often originates from and flows to industries characterized by monopolistic or oligopolistic market traits. Further, certain industrial market characteristics and concentration at home are highly suggestive of the investment location in foreign countries. Available statistical data from the 1950’s until now confirms that this pattern of concentration, which may be decreasing, has nevertheless been one of the most enduring characteristics of the FDI phenomenon. For instance, in 1999, only ten countries received 74% of all FDI and six developing countries received 80% of FDI going to those countries. Subsequent UNCTAD studies, particularly the 2003 and 2004 World Investment Reports, confirm the pattern of concentration and compactness of FDI. The World Investment Report of 2007 announced that multinational enterprises (MNEs) from developed countries remain the main source of FDI, accounting for about 84% of the total FDI outflows. The nature of the concentration of FDI is best captured in Figure 1 below.

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21 Yelpaala, Model Investment Law, supra note 12, at 17-19.
22 The concentration and compactness has been one of the enduring characteristics of FDI since data on the phenomenon has been collected. The United Nations Center on Transnational Corporations [UNCTC] published a study of the salient features of FDI in 1983 which confirmed the pattern of concentration. The study which examined data from the 1960s to the 1970s demonstrated clearly that foreign investment tends to be concentrated in developed countries both in terms of origin and destination. See UNCTC, Salient Features and Trends in Foreign Direct Investment at 1-21, U.N. Doc. ST/CTC/14, U.N. Sales No. E.83.I.A.8 (1983) [hereinafter UNCTC, Salient Features].
In many respects, the FDI narrative provided by Figure 1 not only confirms the historical patterns, but also demonstrates the stark differences between the fortunes of developed countries and those of developing countries. Between 2004 and 2006, the relative position of developing countries and their poorer regions, particularly Africa, remained constantly low. As is apparent from Figure 1, when the world foreign direct investment inflows in 2006 passed the one trillion dollar mark, the FDI inflow to the entire continent of Africa was only about $36 billion. Certainly, the inflow of FDI to Africa had doubled from what it was in 2004 ($18 billion). Nevertheless, it is a sad commentary on the attractiveness of the Continent to FDI, considering the rapid pace of liberalization of FDI policies in the region. Given that many of the post conflict transition countries are on the Continent, the picture cautions against great optimism in the role of FDI in their development and demands great care in the design of an FDI policy framework.28

Second, Figure 1 also confirms the notion that both the origin and destination of FDI tend to be rich and affluent countries. In the post World War II era, the U.S., Canada, Western Europe, and Japan were significant sources and destinations of FDI.29 Consistent with Vernon’s product cycle hypothesis, investors appeared interested then, as they are today, in high per capita

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28 Id. at xvii-xviii; Yelpaala, Model Investment Law, supra note 12, at 74.
countries. According to the World Investment Report of 2007, the United States and other developed countries within the European Union (EU) continue to receive a significant share of FDI inflows. Third, foreign investment tends to be located in the richest regions of rich countries. Fourth, FDI tends to go from rich countries to the richest of the developing countries and tends to be located in the richest regions of developing countries. A series of studies, particularly the most recent UNCTAD study of world foreign investment behavior, clearly confirms the pattern. By rich we mean not only the abundance of financial resources, high per capita income and large markets, but also the abundance of natural resources which are attractive to resource seeking investors or scoop and ship operations. Since 2004, UNCTAD has observed a growing trend in the size or levels of South/South FDI; that is foreign direct investment from some developing countries to other developing countries. However, it is important to stress that developing country origin and destination investment exhibit the same type of concentration described here. Fifth, FDI in Africa is also highly concentrated, with only a few resource rich countries, such as Angola and Nigeria, accounting for a substantial portion of it. Finally, a careful review of studies of FDI in least developing countries (LDCs), landlocked countries

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31 UNCTAD, WORLD INVESTMENT REPORT 2007, supra note 3, at xv.
32 Yelpaala, Model Investment Law, supra note 12, at 17.
33 UNCTAD, WORLD INVESTMENT REPORT 2003, supra note 26; UNCTAD, WORLD INVESTMENT REPORT 2004, supra note 26; UNCTAD, WORLD INVESTMENT REPORT 2007, supra note 3.
34 Yelpaala, Model Investment Law, supra note 12, at 17.
35 UNCTAD, WORLD INVESTMENT REPORT 2004, supra note 26; UNCTAD, WORLD INVESTMENT REPORT 2007, supra note 3.
36 UNCTAD, WORLD INVESTMENT REPORT 2004, supra note 26, at 19-29.
(LLCs) and sub-Saharan African countries (SSACs) exhibit the same basic characteristics discussed above.\(^{38}\)

The pattern of FDI described so far reveals an important lesson that should not escape the attention of any policy specialists charged with constructing the blueprint for transforming post conflict transition countries into productive and sustainable economies. It is abundantly clear from this pattern that foreign investors are cold hearted capitalists motivated by profit and the desire to maximize the value of their firms.\(^{39}\) They have developed a global mind-set that views the world as a single economic space. To them, economic geography is borderless, stateless and with few, if any, insurmountable cultural limitations. With the right strategic vision, the resources of the world, including cultural differences, can be exploited to enhance the value of the firm. In vogue is a capitalist philosophy that has reduced the parameters of management decision processes to the very narrow confines of the interest of the firm, its owners and managers. The constituent interest groups do not extend to the state, labor, consumers or other stakeholders. The mission and responsibilities of management do not include spurring economic development, although investment activities may have such spill-over effects. As described elsewhere, investment decisions are motivated by what may be termed as purer forms of capitalist rationality, which compels investors to seek out the most lucrative markets and business opportunities wherever they may be found.\(^{40}\) Modern corporate governance, management theories and practice subscribe to this capitalist rationality as the norm. It is assumed that shareholders of enterprises engaged in foreign investment expect and demand this capitalist mentality in corporate managers. It is also assumed that social policy concerns, which often occupy the attention of governments and legislatures, seldom, if ever, take center stage in the calculations of shareholders interested in FDI.\(^{41}\)

III. PATTERNS OF FDI IN POST CONFLICT TRANSITION COUNTRIES

If the investor mind-set described above is what policy makers of post conflict transition countries are faced with, what should inform their policy design for transforming those countries if they must rely on FDI? As pointed out above, post conflict transition countries are not normal economies. Most of them are burdened by significant market failures, relative small market size, severe economic constraints and failed or weak institutions necessary for a well functioning economy. Many of them fall into the category of countries described as least developed; they are located in SSA, some of them are landlocked

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\(^{39}\) Yelpaala, Model Investment Law, supra note 12, at 18.

\(^{40}\) Id.; see, e.g., Robert B. Reich, Who is Us?, HARV. BUS. REV., Jan.-Feb. 1990, at 53.

\(^{41}\) Yelpaala, Model Investment Law, supra note 12, at 18.
countries and a few of them may be suffering from the natural resource curse.\footnote{Joseph E. Stiglitz offers some interesting examples of the natural resource curse; the czarist Azerbaijan suffered from it at the turn of the twentieth century and even today many resource rich countries have poor people. Such countries include Nigeria, Peru, Venezuela, Mexico, Papua New Guinea and others. In 1975, the number of people in Nigeria living on less $1 a day was about 19 million. In 2000, that number reached 84 million. \textit{See Joseph E. Stiglitz, Making Globalization Work} 133-137 (2006). Jeffrey Sachs and others have also studied this phenomenon in developing countries. \textit{See Jeffrey D. Sachs \\& Andrew M. Warner, \textit{Natural Resource Intensity and Economic Growth, in Development Policies in Natural Resource Economies} 13 (Jorg Mayer, Brian Chambers \\& Ayisah Farooq eds., 1999); Jeffrey D. Sachs \\& Andrew M. Warner, \textit{The Big Push, Natural Resource Booms and Growth}, 59 J. DEV. ECON. 43 (1999); Jeffrey D. Sachs \\& Andrew M. Warner, \textit{Natural Resources and Economic Development: The Curse of Natural Resources}, 45 EURO ECON REV. 827 (2001).}} Although there are no available statistics dedicated to this group of countries, one can get a sense of their FDI attractiveness from an examination of the categories they fall into.

A study by UNCTAD of FDI in LDCs provides a general picture of FDI flows to LDCs and flows to specific countries, some of which are in post conflict transition.\footnote{UNCTAD, LDCs, supra note 38, at 1-20.} It is observed that in the decades of the 1990s, LDCs appeared to be more attractive to foreign direct investors than in previous decades. For instance, the annual growth rate of FDI to these countries was about 20% and they seemed to be keeping pace with the annual growth rate of FDI to developing countries, which stood at about 22%.\footnote{\textit{Id.} at 2.} While this annual growth rate of FDI might be indicative of the future attractiveness of these countries to FDI, what is of interest to policy makers in developing countries and post conflict transition countries is not so much the size of FDI flows but its impact and contribution to the developmental objectives of the host country. This requires a closer examination of the data.

It would appear that the general positive trend of FDI flows to LDCs masks certain specific troublesome indicators. For instance, FDI flows to LDCs constituted but a very small fraction of total FDI flows to the world and to other developing countries. From 1986-1990, FDI flows to LDCs were only 0.4% and 2.2% of total world and developing countries FDI flows respectively.\footnote{\textit{Id.} at 3.} By 1999, the share of LDCs in world FDI dropped to 0.3%, but its share of total flows to developing countries increased slightly to 2.4%.\footnote{\textit{Id.}} Consistent with the location patterns of FDI, it is hardly surprising that the general picture is that LDCs do not appear to be very attractive to FDI. To the extent that many of the post conflict transition countries fall into this category, one must ask the question what amount of energy should be devoted to attracting FDI unless it is deliberately targeted at some specific industrial policy objectives.

FDI flows to post conflict transition countries face additional difficulties which are characteristic of those countries specifically, and of developing countries in general. First, some countries, such as Angola and the Democratic
Republic of the Congo (DRC), are endowed with significant mineral resources, particularly in petroleum and mining. Others, such as Liberia and Sierra Leone, are known for their diamond deposits. All of these countries stand to attract FDI investments in those sectors. Unfortunately it is also precisely because of these resources and the conflict that there might be capital flight or FDI might be of the wrong origin or the wrong type. In countries such as Sierra Leone, divestments exceeded new investment flows in the 1990s. The DRC experienced significant fluctuations between negative and positive inflows during this period. It is reported that the current government of the DRC is even engaged in various forms of infrastructure for natural resources barter investment schemes with foreign governments and their investors reminiscent of the classic scoop and ship investments. In other countries, FDI may come at significant cost to the host country. Those resources may be in the hands of incompetent bureaucrats or captured by elite interest groups working in cohorts with foreign investors for siphoning away valuable natural resources in scoop and ship investment operations, with little beneficial impact on the development of the host country. Second, their natural resource endowments may also put them in the paradoxical position of suffering from underdevelopment precisely because of their riches.

47 Id. at 7.
48 Chinese investments in the DRC are receiving mixed reviews. Although there are elements of creativity, there is also much fear that they are essentially scoop and ship operations and may ultimately generate more tension with the local communities than would be mutually beneficial. The context and circumstances of the investments are complex and there is not much concrete data for a careful balanced analysis. For the issues raised see John Farmer & Ann Talbot, China Steps up Investment in Congo as War in East Continues, WORLD SOCIALIST WEB SITE, Jul. 15, 2008, http://www.wsws.org/articles/2008/jul2008/cong-j15.shtml (reporting a $9 billion investment deal between China and the DRC in which some of the funds would be used for infrastructure development and mines renovation in return for some minerals); Tim Whewell, China to Seal $9 billion DR Congo Deal, BBC NEWS, Apr. 14, 2008, http://newsvote.bbc.co.uk/2/hi/programmes/newsnight/7343060.stm (outlining the $9 billion China/DRC deal). For some general information on Chinese investment issues in Africa see, Lydia Polgreen & Howard W. French, China’s Trade in Africa Carries a Price Tag, N.Y. TIMES, Aug. 21, 2007 at A1 (discussing the effects of Chinese trade with Africa, such as increased production in Zambia’s copper mines, but closed textile factories due to Chinese imports); Richard Behar, Mining Copper in Zambia, FASTCOMPANY.COM, June 2008, http://www.fastcompany.com/magazine/126/zambia-chinas-mine-shaft.html?page=0%2C0; Richard Behar, Mineral Wealth of the Congo, FASTCOMPANY.COM, June 2008, http://www.fastcompany.com/magazine/126/congo-a-moment-of-truth.html [hereinafter Behar, Mineral Wealth of the Congo] (suggesting some local resistance to the Chinese investments); Richard Behar, China Saps Mozambique of Timber Resources, FASTCOMPANY.COM, June 2008, http://www.fastcompany.com/magazine/126 mozambique-a-chain-saw-for-every-tree.html (suggesting some locals workers are angry over unfair treatment by Chinese investors).; Perhaps one of the most provocative and disturbing online stories is by Peter Hitchens, How China Has Created a New Slave Empire in Africa, MAIL ONLINE, September 28, 2008, http://www.dailymail.co.uk/news/worldnews/article-1063198. One of the difficulties facing scholars is concrete information on Chinese investments in Africa that can inform careful analysis. Without such information these stories will drive the debate, perhaps to everyone’s mutual detriment.
phenomenon generally referred to as the Dutch Disease, discussed in greater detail later. This is a problem claimed to be a perverse characteristic of mineral rich countries where abundant natural resource endowments may be a curse not a blessing. There is, however, another category of countries, such as Angola and Liberia, which seems to have attracted FDI even in their condition as post conflict transition countries. A closer look at that picture reveals FDI behavior very much consistent with the patterns observed above. With significant petroleum reserves, Angola has always been attractive to FDI, despite its post conflict status, particularly in an era of high global energy demand and short supply. Liberia has also experienced relatively high spikes in its FDI inflows during the period, mostly due to Japanese investments aimed at exploiting the tax haven status of Liberia. By any definition of the term, Liberia has been for decades a tax haven attractive to flag of convenience investments. Liberia does not levy any taxes on the foreign source income of Liberia corporations. Finally, landlocked and small post conflict transition countries such as Rwanda face certain constraints in attracting conventional FDI. Not only are their markets too small, but they also face legal questions regarding transit rights if they ship their products by land to foreign markets.

As a group, there are certainly differences in the conditions of post conflict transition countries. However, what emerges from the general and specific analysis of FDI inflows is a picture which screams at policy makers to pay attention if they want to assign a role to FDI in the positive development and economic transformation of these countries. It is obvious that unless great creativity is invoked, an industrial policy design that focuses on FDI in its conventional form is likely to be ineffective and disappointing in results and impact. Transforming post conflict transition countries should be, in the words of Easterly, “homegrown,” based primarily on a domestic industrial policy crafted by “searchers” within the swamps of local conditions. In this context, searchers are those policy makers looking for the type of high value FDI that can make positive contributions to the transformation of the swamp.

Being homegrown does not mean an inward looking policy. Rather, the industrial policy should take into account the resources of the global market place as playing a complementary and supporting role. It seems counterintuitive to call on countries that have been devastated by conflict to take their own fate into their own hands, but the transformation of post conflict transition countries cannot be achieved by outside “planners” relying primarily on conventional FDI. The necessary transformation can best be achieved by the hands of locals with the

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50 ECA, Managing Mineral Wealth, supra note 49, at 22. (a summary of various studies of the impact of mineral resources concluded that being mineral resource poor may be an advantage for a country because the urban and political elite may engage in rent seeking rather than rent creation).

51 UNCTAD, LDCS, supra note 38, at 6-7, 10.

52 UNCTAD, LDCS, supra note 38, at 10.


54 Id. at 17.
savvy and adaptability to take only those FDI resources that will assist them in the task at hand.

If the resources of developing countries have been used, exploited and adapted to keep the industrial engines of many countries of the world running for centuries, has the time not come for developing countries to take a page from self-reliant industrial strategies of successful countries, many of which they have supported to their own detriment with their raw materials? This is the crucial question to be faced by policy makers. In spite of the fact that conditions in these countries might be dim, optimism must guide policy design and implementation. A general FDI policy bundled with generalized incentives, as is rampant in the incentives regimes construct, does not immediately suggest it.

IV SYSTEMS ANALYSIS OF FDI

The argument made so far is not that FDI cannot contribute to the economic development of a host country. Rather, it is that FDI in one country may contribute to the development of other countries, while at times imposing a cost on the host country. Further, it is also argued that in order for FDI to transform developing countries, particularly post conflict transition countries, some positive and proactive measures must be taken to ensure that FDI fits into some domestic investment demand systems, such that FDI creates the necessary spill-over effects and internal linkages with the local economy. It will be argued later that FDI in its conventional form is unlikely to deliver the goods. The importance of these points is best illustrated by the internalization theory of MNEs, which is essentially a systems theory of FDI. Most of the major foreign direct investors that hold great promise for a positive transformative impact on the economies of host countries are MNEs.

According to the internalization theory of the MNE, MNEs exist as a result of a Coasian transaction cost analysis of the rise of the firm within open market transactions. In other words, just as the origins of the firm is traceable to the minimization of transaction costs in dealing with open markets, similarly can the origins of FDI by MNEs be traced to the avoidance of costly market imperfections. MNEs engage in FDI through subsidiaries to create their own internal markets in order to circumvent various market imperfections associated with dealing with open market transactions in the primary and intermediate goods markets. In this sense, FDI is triggered by certain failures of the law of contract. Put differently, FDI is used to avoid various contract performance difficulties associated with dealing with independent parties in the open markets. FDI involves long term relationships which, if carried out through third party

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57 Yelpaala, *Alternatives to Tax Incentive*, supra note 56, at 221.
contracts would be obligationally and contingently incomplete. In other words, the parties could not specify all their obligations nor could they adequately address all future contingencies in the contract. Thus, long term contracts are generally incomplete and burdened by bounded rationality.\textsuperscript{58}

Through FDI, MNEs are able to bypass the problems of incomplete contracts and bounded rationality. This is more so when the investment in the host country involves asset specificity. Asset specific investments tend to expose MNEs to certain vulnerabilities. Asset specific investments suffer from what has been described as a lock-in effect, in that once invested they are they cannot easily be converted to other uses.\textsuperscript{59} In the event of liquidation, their salvage value is minimal as compared to the initial cost of investment. Whether that asset specificity is of a dedicated, site specific or cheek-by-jowl (side-by-side) nature, the investor is exposed to a variety of \textit{ex post} contractual opportunism or expropriation by the host country.\textsuperscript{60} The MNE system minimizes these risks through integration or internalization.

Other market imperfections the MNE has to plan for involve raw materials supply contracts, which may present quality and delivery problems that cannot easily nor adequately be solved by contractual provisions.\textsuperscript{61} Moreover, the use of alternative market entry options such as licensing may also be fraught with various difficulties. Licensing of firm specific intangible assets involves the use of information markets which are almost always imperfect and characteristically burdened by the Arrow’s paradox.\textsuperscript{62} Price negotiations and performance are likely to be affected by \textit{ex ante} and \textit{ex post} opportunism, a phenomenon that has engaged the attention of institutional economists such as Oliver Williamson.\textsuperscript{63} Thus, technology, know-how and other intangible assets that are essential for transforming countries are not easily handled in open market transactions involving independent third parties. Besides, it is often better to use FDI as a technique for minimizing the cost of exporting through tariff skipping.

Faced with these market imperfections, the MNE, through FDI, integrates, internalizes or brings under its ownership and control all those activities for which it could not rely on the open market to achieve its corporate strategic vision efficiently or effectively.\textsuperscript{64} The internalization theory of FDI is therefore a deliberate choice of investment activities that links countries into the corporate network or system of operations. While there is some debate over whether

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\item \textsuperscript{58}Oliver E. Williamson, \textit{The Economic Institutions of Capitalism} 54 (1985) [hereinafter \textit{Williamson, Economic Institutions}]; Oliver E. Williamson, \textit{Markets and Hierarchies: Analysis and Antitrust Implications} 22-23 (1975) [hereinafter \textit{Williamson, Markets and Hierarchies}].
\item \textsuperscript{59}Williamson, \textit{Economic Institutions}, supra note 58, at 54.
\item \textsuperscript{60}Id. at ___.
\item \textsuperscript{61}Buckley & Casson, supra note 56, at 40-41; Yelpaala, \textit{Alternatives to Tax Incentive}, supra note 56, at 221-222.
\item \textsuperscript{62}Yelpaala, \textit{Alternatives to Tax Incentive}, supra note 56, at 220-234.
\item \textsuperscript{63}Williamson, \textit{Economic Institutions}, supra note 58, at 21-22.
\item \textsuperscript{64}Buckley & Casson, supra note 56, at 37; Yelpaala, \textit{Alternatives to Tax Incentive}, supra note 56, at 254-258.
\end{itemize}
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internalization constitutes a general theory of the MNE and FDI\(^{65}\), its systems characteristics are of great importance to policy makers charged with the responsibility of ensuring that FDI contributes positively to the economic development and transformation of their countries. An appreciation of the response to these market imperfections and the specific assets vulnerabilities by MNEs is critical for sound policy design.

It is obvious from the discussion so far that FDI by any MNE does not necessarily constitute a simple isolated investment in the host country. Rather, each FDI operation forms part of a system, a network of interdependent and interconnected operations pursuing a general MNE corporate strategic vision. The system provides the parent with great flexibility since it operates essentially an internal market of its own which excludes outsiders and the open market from its intra-firm transactions. Through this internal market, it can shuttle its resources within the system to achieve various objectives which would have been difficult, if not impossible, if it had to rely on third parties in an open market setting. This does not mean that the FDI operations constitute a complete closed system. The internalization theory states that where the market will work well the MNE will rely on outsourcing, delocalization and other forms of external open market transactions.\(^{66}\) What is important to note is that these transactions that rely on other efficient producers, wholesalers or channels of distribution are not FDI based. The MNE and its FDI system we have tried to outline here are best captured in Diagram 1 below.


\(^{66}\) See, e.g., Buckley, *supra* note 65; Buckley & Ghauri, *supra* note 65.
As is apparent from Diagram 1, the MNE system has a spider web structure that may be composed of different clusters of subsidiaries that are both interconnected and interdependent. The network is also at once centralized and decentralized, thereby capturing its monocentric and polycentric characteristics not shown in the diagram. In the center of the web may be found the parent corporation surrounded by its immediate group of subsidiaries and together they form a corporate group. These subsidiaries may be vertically or horizontally integrated in the same line of business as the parent, thereby constituting a unitary business system in a narrow sense of the term. When the MNE system is composed solely of a parent and a group of closely integrated subsidiaries as shown in Diagram 1, it may be described as having a unitary structure or the U-Form, referred to above as monocentric.

In the U-Form, the parent corporation tends to play a direct and dominant role in the establishment and operations of the subsidiaries. By setting the strategic vision of the group, and through technology transfer, loans, and other transactions with the subsidiaries, the parent maintains direct links with them beyond its share interest. Each subsidiary may be strategically designed to play a certain role in the system and in the achievement of various corporate objectives. Individual subsidiaries may then be required to sacrifice profits to enhance some group objective, such as capturing a better group market position or achieving higher overall group profitability. The intimacy of the relationships within the U-Form is further facilitated by integration which also enhances interdependence and interconnectedness. As pointed out above, integration eliminates some of the vulnerabilities inherent in asset specificity. But intimacy between parent and subsidiaries and among subsidiaries in the U-Form only emphasizes the group and systems character of the MNE.

Although the typical major MNE has hundreds of subsidiaries within the system of geographically dispersed operations, Diagram 1 illustrates only a simplified version of the system of flexibility in the FDI system. In Diagram 1 there are six subsidiaries: two raw materials supplier subsidiaries, two manufacturing subsidiaries, one subsidiary in the target market and one in a tax haven. Generally, the larger the number of subsidiaries in each category, the greater the flexibility of the parent since it can shift or shuttle resources within them in response to various geopolitical conditions. It can also engage in income stripping and various transfer pricing practices to benefit the group by realizing higher profits in low tax regions, in this case, the tax haven subsidiary.

From the point of view of policy makers it is critical to ask why the system might be vertically and horizontally integrated with geographically dispersed raw materials and manufacturing subsidiaries. To some extent, the answer appears to lie in the actual or perceived vulnerabilities associated with locating irreversible, high value asset specific investments in a single country. FDI in a single country that involves both site specific or cheek-by-jowl operations, and the extraction and procession of raw materials, may be perceived as exposing the investor to the asset specific vulnerabilities discussed above. From the point of view of the MNE, such complementary investments provide the host country with a complete production system and an invitation for post investment direct or indirect expropriation. At the very least the perceived incentives for post contractual opportunism are magnified.

We recognize that geographically dispersed site specific investment may be designed to achieve many other MNE objectives, such as taking advantage of low labor costs and high productivity and quality. However, in many developing countries the concerns of MNEs may lead to a strategic fragmentation of their operations. This is perhaps best captured by the aluminum industry in Ghana, where there is a smelter which produces ingots from bauxite imported from Jamaica and the finished
products are manufactured in the U.S.\textsuperscript{68} Although the reasons for locating the smelter in Ghana are numerous, the fragmentation of the industry reduces the vulnerabilities of the MNE not only in Ghana but also in Jamaica. Anyone vaguely familiar with the political economy of Ghana at the time the smelter was built will immediately appreciate the significance of that decision within the context of the asset specific vulnerabilities analysis.\textsuperscript{69}

It would therefore appear that the system as described above makes sense within the framework of the mission or strategic vision of the MNE. As discussed above, managers of MNEs see their task as putting the corporation in the best position to increase the value of the firm. The pursuit of these corporate objectives may not advance any specific objectives of any of the host countries in the system. Indeed, the accretion and the distribution of the benefits from the operations of the MNE system among the countries in the system may be uneven or inequitable. The countries that contribute the most to the value of the enterprise may be the recipients of the least benefits. Such might be the case of the raw materials supplying countries where the operations of the subsidiaries are simply \textit{scoop and ship} with no internal linkages with the local economy. Since there is no local procession, there is no local value-added activity, nor does the host country gain from technology transfer, know-how creation and learning by doing.\textsuperscript{70} But these are the very activities that could help in the transformation of a country. On the other hand, the host countries in which the processing or manufacturing takes place stand to gain, perhaps at the expense of the supplier countries. They benefit from the technology transfer and the positive spill-over effects of manufacturing. They also gain from the value-added activities and the linkage with the local economies. And, the tax haven country may perhaps be called a parasitic state that benefits from the values created in the other countries and the consequent capital accumulation and positive balance of payments accounts when no associated activities take place within its borders.

What should be stressed is that notwithstanding the spread of investment liberalization policies and bilateral investment treaties in the last decade, countries do not necessarily control when and how they become part of the system. The choice of which countries are brought into the MNE system is essentially the choice of the parent MNE based on how each country can contributes to its strategic objectives. However, and equally important, is the fact that the uneven distribution of benefits among the countries in the system is a consequence of the corporate strategy but not \textit{necessarily} based on some deliberate calculation of the parent MNE.

\textsuperscript{68} DAVID HART, THE VOLTA RIVER PROJECT: A CASE STUDY IN POLITICS AND TECHNOLOGY 60-61 (1980).
\textsuperscript{69} Id. at 60-61.
\textsuperscript{70} UNCTAD, RETHINKING FDI, supra note 11, at 66.
V. POST CONFLICT TRANSITION COUNTRIES AND THE MNE SYSTEM

In the context of post of conflict transition countries, three countries, Angola, the DRC and Liberia best exemplify the nature of the FDI flows to post conflict transition countries and the role of those countries in the functioning of the MNE network of subsidiaries. The flow of FDI is captured in Figures 2 and 3 below merely as suggestive evidence since there is no available and credible information on the number and types of subsidiaries in those countries.

![Figure 2](image)

The purpose of Figure 2 is to demonstrate the relative insignificance of FDI flows to post conflict transition countries in Africa even as the Continent as a whole has remained largely unattractive to FDI relative to the rest of the world and other regions. With the exception of Angola which, similar to other oil producing countries, attracts FDI the experience of other countries is significantly dwarfed by the $35 billion FDI flows to the continent as a whole in 2006.
However, Figure 3 below provides a much more dramatic depiction of the nature and limitations of FDI as an instrument for pursuing direct and positive development objectives.

The dominant theme in Figure 3 is the volatility in the FDI flows to these countries which imposes severe challenges on policy makers seeking to assign a sustained developmental role to FDI. Volatility in FDI flows might suggest some crisis of confidence in the political and security conditions in these countries which would inhibit irreversible specific asset investments. Volatility in FDI flows might also be indicative of transitory investment in high risk and high returns activities which often visit significant negative consequences and anti development impact on the host country.

As an oil producing country, Angola is by far the most attractive to FDI in this sample of countries and shares that level attractiveness with other oil producing countries on the Continent.\footnote{UNCTAD, \textit{WORLD INVESTMENT REPORT} 2003, \textit{supra} note 26, at 34 (discussing the concentration of FDI in Africa, predominantly in oil rich countries such Nigeria, Angola, Chad and Tunisia).} In spite of its attractiveness to natural resource seeking investments, Angola also suffers from the same swings in investment flows. In 2003 FDI in Angola reached its peak in the era, $3,500
million, only to be followed by declines culminating in significant negative inflows three years later. Lower levels of volatility were experienced by Liberia and the DRC. What is perhaps significant about the DRC is that the country is reported to be endowed with significant quantities of all minerals known to man yet the FDI flows to that country are hardly reflective of its potential. On the other hand, FDI flows to Sierra Leone shows an insignificant but crawling upward trend. In short, whatever the reasons for this volatility in FDI might be, it does not bode well for a country trying to rely on FDI as an instrument for development.

All of the countries examined here have been part of the network of countries brought into the MNE system as suppliers of raw materials and Liberia also as a tax haven. Even during its internal conflict, Angola remained attractive to foreign investors, primarily in the petroleum sector. In its post conflict transition phase, Angola has remained one of the leading overall recipients of FDI in Africa, but still primarily in the petroleum sector. Endowed with significant amounts of extractive natural resources, the DRC has been attractive to natural resource seeking FDI. However, with weak institutions, persistent post conflict security challenges, poor governance, and without an industrial strategic policy architecture of the type advocated for in this study, the DRC seems to have had flirtations with perhaps the wrong types of foreign investors in its extractive industries. As raw material suppliers, neither country benefits from value added activities, technology transfer and linkages with their local economies. The case of the DRC deserves particular attention. In the normal context, raw material supplier countries in the MNE system do not stand to benefit significantly when they are purely in that role. In the case of the DRC, the continuing tensions and administrative difficulties the country faces raise serious questions about what benefits it can even reap from its position as supplier of raw materials. The internal governance difficulties and uncertainties faced by post conflict transition countries, such as Angola and the DRC, do not make them attractive to irreversible site specific conventional FDI.

Unlike Angola and the DRC, Liberia plays a dual role in the MNE system. It has been both a supplier of raw materials and a tax haven for MNEs. Starting with the notorious Firestone Rubber Plantation at the turn of the 20th century, Liberia became a major supplier of iron ore to American and Swedish industries in the 1960s. These MNEs established just enough railroad transportation links

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72 See Behar, Mineral Wealth of the Congo, supra note 48 (the DRC has 10% of the planet’s known copper, 30% of its cobalt, 80% of its coltan used in everything from playstations to ipods to gadgets and many others).
73 UNCTAD, WORLD INVESTMENT REPORT 2004, supra note 26, at __; UNCTAD, LDCs, supra note 38, at __; UNCTAD, RETHINKING FDI, supra note 11, at __.
74 Behar, Mineral Wealth of the Congo, supra note 48 (reporting that many of the natural resource investors are essentially rogue investors systematically exploiting the country and taking whatever they can with impunity).
75 Id. (arguing that life in the DRC is too precarious and the general environment is too chaotic and dangerous for an orderly exploitation of its vast resources, but this might be the best reason for the measures advocated in this project).
76 See WOLFGANG G. FRIEDMANN & JEAN-PIERRE BEGUIN, JOINT INTERNATIONAL BUSINESS VENTURES IN DEVELOPING COUNTRIES 55 (1971) (In a chapter the authors provide a full
between the mining sites and the port to facilitate the export of the ore for processing elsewhere. Hardly any internal linkages were made with the local economy, nor did the operations foster the developmental goals of the country. Despite the efforts of policy makers, subsequent timber concessions granted in the 1970s suffered a similar fate. Thus, Liberia was and remains largely unattractive to irreversible high value site specific or cheek-by-jowl investments. As a prototypical small country, the small local market size cannot support the economies of scale essential for market seeking FDI.

One of the enduring characteristics of Liberia’s international economic policies has been openness. Throughout its history, in crisis and challenging economic times, Liberia remained wedded and unwavering in its commitment to an open economy. An important aspect of this open policy is a liberal tax jurisdiction which is based on the territoriality or source principle. That is, Liberia does not levy any taxes on income earned by Liberian nationals or corporations outside its territorial borders. Thus, Liberian subsidiaries of foreign MNEs are only subject to taxation for income earned within Liberia. In addition to the policy of an open economy, Liberia is also a “flag of convenience” state which allows the registration of foreign owned ships in Liberia.

The combined effects of these policies are that Liberia is attractive to FDI motivated by the benefits conferred by a tax haven. This has wide ranging implications for the country if FDI is to play a meaningful role in its economic development. To the extent that income earned outside Liberia is not subject to Liberian taxes, there is hardly an incentive for foreign investors to engage in activities, transformative or otherwise, within the country that would subject

discussion of the LAMCO joint venture and its impact on Liberia); DAVID N. SMITH & LOUIS T. WELLS, JR., NEGOTIATING THIRD WORLD MINERAL AGREEMENTS 39 (1975) (hereinafter SMITH & WELLS, THIRD WORLD MINERAL AGREEMENTS) (explaining in chapter two the structure and substance of mineral agreements in Liberia, arguing that the terms were largely unfavorable and that the financial arrangements of the Liberian-National Iron Ore Company Agreement of 1958 “were so disadvantageous that the most charitable interpretation must be that the issue was not clearly understood by Government negotiators”); Stefan Gullander, Joint Ventures and Corporate Strategy, COLUMBIA J. WORLD BUSINESS 104, 113-114 (1976) (discussing the complex joint venture arrangements involving the exploitation of Liberia’s mineral resources). For an extensive discussion of the history and the different phases through which mineral and petroleum and mining agreements moved, see U.N. CENTER ON TRANSNATIONAL CORPORATIONS, MAIN FEATURES AND TRENDS IN PETROLEUM AND MINING AGREEMENTS, U.N. Doc. ST/CTC/29, U.N. Sales No. E.83.II.A.9 (1983) (hereinafter UNCTC, TRENDS IN PETROLEUM AND MINING AGREEMENTS).  


them to taxation. In a perverse way, the tax haven status of the country discourages the type of high value investments that would be beneficial to its economic development because, as much as possible, income generating activities will be engaged out of jurisdiction. There is an obvious incentive for FDI in the extractive industries to be primarily *scoop and ship* operations.\(^79\) Local processing which generate higher value would also subject a higher amount of operational revenues to local taxes. It is therefore hardly surprising that since the 1990s Liberia has attracted relatively large amounts of “flag of convenience” FDI primarily from Japan.\(^80\)

Flag of convenience FDI is essentially a tax haven bookkeeping device that does not involve any actual capital inflow. The value of the ships registered under this process constitutes the FDI. Such bookkeeping driven investments while very valuable to the MNE, are *slippery and easily switchable* between jurisdictions in the bookkeeping process. Moreover, since the ships are likely to be used in international trade between countries and points outside Liberia, the income generated in that process will escape Liberia taxation.\(^81\) Thus, Liberia may be used as an instrument for sheltering income of other countries from taxation without the positive capital accumulation effects. The flexibility inherent in the MNE system makes this not only possible but also easy.

Of course, the political economy of Liberia is a very complex one which cannot be addressed here.\(^82\) However, if the goal of the liberal tax jurisdiction regime and the “flag of convenience” policy is to encourage FDI for the economic development of the country, that goal may be elusive. Viewed as a regime, these policies would encourage the least amount of operational activities in the country, particularly in the extractive industries where the country has natural endowments and comparative advantage. That is, FDI operations would involve mostly the extraction and export of raw materials which would deny the country beneficial value-added activities, technology transfer and essential links with the local economy. They would also discourage irreversible investments and encourage transitory FDI with little or no actual capital inflows. In particular, “flag of convenience” investments in a tax haven such as Liberia are likely to contribute less to economic development. By their very nature nothing may be done or is required to be done in the host country. In a vertically or horizontally integrated MNE system, significant amounts of income may be earned by Liberian registered ships without contributing any value to the local economy except the registration fee. In all of these cases the contribution by FDI to the development of Liberia would be minimal unless some proactive development driven policies are put in place.

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\(^79\) Gullander, *supra* note 76.


\(^82\) Yelpaala, *Dissertation, supra* note 78.
The preceding discussion of the MNE FDI system suggests a few important points that should engage the attention of policy makers concerned about the contribution FDI can make to their local economic development. It is obvious that given the functional dynamics of the MNE system, no country can count on conventional FDI making the type of contribution it needs for its growth and economic development without some guidance. However, policy makers must command a thorough but neutral understanding of the system. By neutrality we mean that policy makers should refrain from attributing a deliberate intent of MNEs to visit harm on the interest of countries. Unless the evidence warrants it, such an attribution of a harmful intent might detract policy makers from the fundamentals of sound policy design. Rather, policy makers should focus on the actual or perceived vulnerabilities of MNEs and the cost and benefits of the system on their economies. In other words, the search for the contributions of the MNE system to local economies must be a double-sided search that involves a series of questions.

First, what motivates MNEs in the choice of participating countries in their systems? Put differently, what is the role of any specific FDI from the point of view of the investor? Why are some countries suppliers of raw materials and others manufacturers of products? What contributions to the system are expected from each of the countries and their subsidiaries in the system? What local conditions in each host country might contribute to the position of that country in the MNE system? Second, what can FDI investment do for the transformation of their economies rather than what can FDI do for the country? In view of the fact that the distribution of the benefits of the MNE system among the participating countries might be uneven or even inequitable, which type of FDI operations could positively alter the distribution of those benefits? Which types of FDI are likely to expose the host country to negative externalities in the form of social and environmental costs, or expose the vulnerability dependence associated with the volatility of the global economy? Indeed, the risks of detrimental impact associated with certain investments are too high for policy makers to ignore these critical and fundamental issues.

In the specific case of post conflict transition countries, this understanding is even much more crucial since they are likely to face several additional problems and constraints. The sample of countries examined here, Angola, the DRC and Liberia, all fit well into the model of the MNE system discussed above. All three countries have been long time suppliers of raw materials. This would seem to suggest that MNEs in those countries made decisions which minimized certain uncertainties or avoided the vulnerabilities associated with irreversible high value asset specific investments in local processing or manufacturing. Yet, the raw materials demands of MNEs are such that they made investments even in the midst of political turmoil and severe insecurity. So, even during its internal conflict, Angola continued to attract FDI, primarily in the petroleum sector. Notwithstanding the volatility of its political conditions, Angola remained one of

83 Yelpaala, *Cost and Benefits of FDI*, supra note 8, at 97.
the leading recipients of FDI in Africa. Also, in spite of governance difficulties, the DRC also attracts investments in the extractive industry. As discussed above, within the context of the post conflict chaos and governance difficulties that seem to exist within the DRC, it is doubtful how much benefit the country could receive in its position as raw material supplier.

VI. TRANSFORMATIVE INDUSTRIAL STRATEGIC POLICY ARCHITECTURE

The task of this endeavor is of a very limited nature. The goal is to determine what role FDI might play in the transformation of post conflict transition countries. Unfortunately, time constraints and space limitations prevent this study from fully addressing all of the complex issues of macroeconomics, industrial policy and industrial legislation that this topic deserves. Thus, the following discussion is tailored to exploring and developing a framework or a blueprint that directs the debate away from conventional FDI as an instrument for growth and development of post conflict transition countries.

We will propose a transformative industrial strategic policy architecture in which non-conventional FDI plays a complementary role as an engine of development within a carefully crafted domestic investment demand. What is proposed here is a direct reversal of roles in the creation of MNE FDI systems in which the host country exercises greater control over the type, timing and duration of FDI. Through screening, targeting and sequencing, industrial projects and technologies with the greatest potential for generating sustained growth and development should be funded through a Project Finance and Build Operate and Transfer format. As will be explained below, project sponsors, as foreign investors, should play an important but transitory role in responding to the developmental objectives of the host country for profit. In that context, we shall argue that conventional neo-liberal, anti-state market based prescriptions that dominated the decades of the 1980s and 1990s are perhaps misguided and ill suited to the needs of post conflict transition countries in search of instruments for development. This is particularly the case when uncompromising market based principles are preached and imposed on countries where market failure of the first order dominates their economies.

1. Contexting the Strategic Policy Architecture of the Post Conflict State

The picture painted earlier of the post conflict transition state within the system of traditional FDI raises serious questions about whether FDI can play a meaningful transformative role in their economic development. First, from the point of view of the strategic mindset of MNEs, post conflict transition countries play only some role in the achievement of their corporate objectives. Any developmental impact of MNE activities in the host country is a by-product or consequence and not necessarily a directed corporate objective. Second, certain prevailing conditions in post conflict transition countries make them attractive
only to certain types of conventional FDI with limited transformative possibilities. We have already addressed these above. However, for emphasis and to clarify the approach advocated below, a summary of the conditions of post conflict transition countries is necessary.

By various classifications of countries by the United Nations, its organs and other international institutions, post conflict transition countries are some of the poorest countries in the world. Some of them fall into the category of countries classified as least developed countries, fragile economies or landlocked. Some of these countries belong to more than one of these categories. Several of them are found in Sub Saharan Africa, a region notorious for consistently lagging behind other developing countries in its basic economic indicators such as GDP growth, per capita income and general economic performance. Standing alone, most post conflict transition countries constitute small markets either because of their population or because of low per capita income. Such is the case of Liberia and Sierra Leone. Others, such as the DRC, with larger population and greater market potential, lack basic infrastructure, transportation, and telecommunications that can support a successful marketing strategy. In response to the limitations of small markets and the demands of economies of scale for production that can support market seeking manufacturing FDI, cross-cutting and overlapping regional trade organizations and free trade agreements have mushroomed in Africa. For instance, COMESA, of which Rwanda is a member, has 19 member countries that stretch from South Africa to Egypt. Covering larger geographic areas with huge populations and diverse economies, one would have thought that the market size problems faced by manufacturing FDI would have been removed by the formation of these regional trade organizations. Unfortunately, the intended regional markets are also hampered by similar inadequate infrastructural linkages and other barriers to effective marketing. Thus, the effective markets for FDI continue to be national markets.

With these conditions and constraints, post conflict transition countries appear to be unattractive to high value FDI with the transformative capacity they need. From our earlier discussion of the enduring characteristics of FDI, the poorest of poor countries are hardly ever attractive to MNEs in search of markets and profits unless those countries are endowed with abundant natural resources. Besides, in view of lingering security questions and the vulnerabilities associated with specific asset investment inherent in long term irreversible and high value FDI, conventional FDI has tended to be primarily in the extractive or natural resource industries. Designed to minimize investor exposure to vulnerabilities, and purely for the export of raw materials, these types of operations cannot transform the host country. Instead, they tend to expose the host country to the vagaries and volatilities of the world commodity markets.

It is clear from this summary and the arguments advanced so far that left alone, FDI cannot deliver the goods on growth and economic development in post transition countries. Indeed, it seems that such an expectation of MNEs would be a mismatch of expectations and responsibilities. The primary objective of MNEs is not economic development, although they stand to benefit from it and can contribute to it. On the other hand, economic development is one of the

84 See supra notes 20-37..
primary responsibilities of the state. And it is incumbent on the state to take all necessary measures to achieve its developmental objectives. For developing countries in general, the evidence so far seems to suggest that economic development cannot easily be achieved without some deliberate and active state intervention. The State cannot relinquish that responsibility to the so-called pure market forces guided as it were by the invisible hand. Just as a farmer tilts the land, plants and nurtures his crops for a great harvest, so must the State take measures for the development of its economy. This is the context in which one must see the role of post conflict transition countries in the design of an industrial strategic policy architecture for development.

2. Modeling Industrial Strategic Policy Architecture: Lessons from Success Stories

The argument advanced is not that market principles are not relevant in fundamental industrial policy design. Rather, it is that post conflict transition countries in search of techniques to jump start their economies should benefit from the lessons of recent success stories of other countries. In particular, they should look to the newly industrializing economies (NIEs) of South East Asia for clues and ideas that could inform their choice of policies and techniques for laying the framework for development. The lessons from this region are particularly instructive given that the countries do not constitute a homogeneous group. In an informative and careful study of a sample of 119 countries, John Page offered some reasons for the miraculous success of these countries. At the outset, he pointed out that the East Asian miracles are hardly homogeneous or monolithic in culture, economic conditions, resources, population or historical experience. In spite of such diversity, they all shared certain common characteristics in their success. They all enjoyed simultaneously sustained growth and equitable distribution of income. That is, they debunked the view once held that there is an inverse relationship between growth and equity. Instead they demonstrated that high levels of growth can be positively correlated to high income equality. For, as these economies enjoyed unprecedented growth rates the gap between the rich and poor simultaneously narrowed significantly. The policy architecture that produced such miraculous results is worth the attention of other developing countries, particularly countries in search of a framework for development after conflict and major economic disruptions. The critical question is what policies produced these impressive results?

The answer to this question is particularly important to countries that have suffered severe and untold devastation, but coming out of that face the opportunity for a fresh bold start. However, according to Page, there are two schools of thought with respect to the reasons for the East Asian miracle. One school, the fundamentalists, hold that these countries relying on market principles got the basics right. They focused on policies that increased physical and human

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85 Page, supra note 7, at 219.
86 Id. at 220.
87 Id. at 223.
capital per worker and efficient allocation of resources. In essence, they concentrated on getting the “price right.” The mystics, on the other hand, argued that markets have consistently failed to guide investments into industries with the greatest potential for growth. It was activist governments in the region that intervened directly in getting the “price wrong” by channeling investments and technologies into predetermined industries and projects with the greatest potential for growth which normal market forces would have rejected. It would, however, appear that the explanation of the success of NIEs is too complex to be cast in an either or choice between the fundamentalist and mystics arguments.

The overall evidence from Page and numerous other studies suggests that a combination of fundamentalist and mystic policies played a significant role in the productivity growth and development of these countries. It appeared that all countries, at different phases and at different rates, combined market oriented capital accumulation and allocation policies with state interventionist policies that promoted specific industries and technologies believed to have high value transformative effects. More specifically, common to all countries were the combinations of the following policies: (1) market oriented capital accumulation and allocation, (2) state interventionist policies that promoted specific industries and technologies, (3) unusual macroeconomic stability spurred by sound policies and management, (4) improved integrity of the banking systems with carefully designed and monitored directed credit that increased profitability for the banks, (5) educational policies that focused on primary and secondary education which generated a rapid increase in the pool of skilled labor force and (6) agricultural policies which did not over taxing rural communities.

Without diminishing the significance of the other complementary policies, it would appear that rapid human capital growth was perhaps the most important element in the success of the industrial policies pursued. The industrial targeting policies and the manufactured export orientation based on new technologies all required a skilled labor force. High productivity growth, high quality output and efficiency driven low cost production, which in turn were also essential for global competitiveness of their exports, could not have been achieved without a growing pool of skilled labor. Perhaps, one of the most important reasons for the high simultaneous growth rates and the rapid narrowing income gap was the emphasis on increased supply of skilled labor achieved through primary and secondary education. Without such resources, the achievement of the industrial transformation as designed would have been difficult, if not impossible. But as skilled labor productivity increased, so were their rewards in wages and other compensation, which then narrowed the income inequality gap.

88 Id.
89 Id. at 224.
90 See e.g., Page, supra note 7, at 234; SAKONG, supra note 5, at __; Scitovsky, supra note 5, at __.
91 Page, supra note 7, at 234.__.
92 Id. at 234.
3. The Role of the Developmental State

One of the important lessons to be discerned from the success stories of the East Asian Miracles is the role of the “developmental state” in economic development. The “developmental state” is one which does not approach the development task as a dichotomized tension between the state and markets, seen by neo-liberal economists and the so-called Washington Consensus virtually as incompatibles. Nor does it see any bipolarity between market-driven export led growth and an inward looking or import substitution development agenda. The development task of these countries does not easily fit into such simple dichotomies or bipolarities. It is not the simple choice between free and unfettered markets and “statist” restrictive and protectionist policies. Nor is it between a domineering or dominant state control over entrepreneurial decisions and free market structures. Rather, it calls for marshalling various forces of the political and bureaucratic elites, entrepreneurs and industry leaders, various economic rent seekers and other stakeholders into a symbiotic organism with a single national mission for industrial development.

The pessimists and skeptics might view the success of these East Asian Miracles as too much of a cultural phenomenon unique to that region and therefore of little value to post conflict transition countries. If so, one might ask why neo-liberal free market driven policies have transcendent cultural and universal characteristics. Moreover, as pointed out by Page, the East Asian Miracles are hardly culturally homogeneous, yet they employed similar industrial policies with similar remarkable results. Certainly, culture plays some role in how a sound industrial policy might be adapted in any country, be it Liberia, Bosnia or Angola. However, the soundness of an industrial policy emphasizing high value manufacturing investment is not culturally driven. Besides, why should any person put a ceiling on what other peoples or cultures can do in any country by denying them access to successful and workable models? Some might even call the approach used by the successful countries as “state capitalism” in a pejorative use of the term, suggesting that there is only one road to development and it is the unfettered free market system. Diversity of development theories

93 UNCTAD, RETHINKING FDI, supra note 11, at 59-60 (arguing as follows: The ideology of the developmental State as fundamentally “developmentalist”, as its major preoccupation is to ensure sustained economic growth and development on the back of high rates of accumulation, industrialization and structural change. Structurally, such a State has (or develops) the capacity to implement economic policies that effectively delivers development, which in turn gives it legitimacy.); Kojo Yelpala, The Impact of Industrial Legislation on the Behavior of Multinational Enterprises and Labor in the Industrializing Countries of East and South East Asia, 6 Mich Yrbk Int’l Legal Stud. 383 (1984) (explaining the use of coherent industrial legislation across sectors and labor and its impact on foreign investment conduct) Gunnar Myrdal, ASIAN DRAMA: AN INQUIRY INTO THE RECOVERY OF NATIONS (1968); Manuel Castells, The Four Asian Tigers with a Dragon Head, in STATES & DEVELOPMENT IN THE ASIAN PACIFIC RIM 33-70 (Richard Appelbaum & Jeffrey Henderson eds., 1992); Thandika Mkandawire, Thinking about Developmental States in Africa, 25 Cambridge J. Econ. 289-313 (2001)

94 Page, supra note 7, at 220...

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and instruments cannot be a detriment but rather a major asset unless we underrate the adaptive capacity of humanity.

The experience of the Asian Miracles suggests that what post conflict transition countries need is an industrial policy design that is outside conventional norms but well suited to their developmental needs. The push for non conventional policy design is nothing extraordinary. It conforms with the earlier call for creativity of the first order if post conflict transition countries are to be transformed amidst the significant and extraordinary circumstances they face. It is also consistent with a growing unease with the once dominant neo-liberal policy prescription of the 1980s and 1990s. A paradigm shift seems to be in the offing among development economists about the role of the state in development. And, institutions such as the World Bank and many development economists seem to recognize the limitations of the neo-liberal economic policy prescription for developing countries. The neo-liberal anti-state, market-oriented approach to development policy has not borne fruit in many poor countries, and not from the lack of effort. As Easterly might describe it, the diagnosis and medicine of “the “Planners” have not worked.” The task of poor developing countries and particularly those emerging from years of conflict cannot be left solely to preconceived market forces. The task requires the hand of an activist “developmental state” that must harness and weld together a multiplicity of forces into a symbiotic organism with a single national economic development mission.

96 The need for and impact of neo-liberal structural adjustments for countries that experienced serious economic malaise have been a subject of much debate in various circles including the Economic Commission for Africa and economists. For a discussion, review and the results of the structural adjustments programs see Ikubolajeh Bernard Logan & Kidane Mengisteab, IMF-World Bank Adjustment and Structural Transformation in Sub-Saharan Africa, 69 ECON. GEOGRAPHY 1 (1993). After several years the IMF and the World Bank are not exactly celebrating the success of the structural adjustment policies. In its 2005 publication, the World Bank discusses the issues of global development finance, managing vulnerability and the failures of FDI and the severe challenges to eradicating poverty. See WORLD BANK, GLOBAL DEVELOPMENT FINANCE, MOBILIZING FINANCE AND MANAGING VULNERABILITY (2005) [hereinafter WORLD BANK, GLOBAL DEVELOPMENT FINANCE]; STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS, supra note 95, at 18 (Stiglitz, a Nobel Prize winner in Economics in 2001, Chairman of President Clinton’s Council of Economic Advisors and Chief Economist for the World Bank provides a very critical inside view of the World Bank and the IMF and concludes that the structural adjustment program failed to bring sustained economic growth even to those countries that adhered strictly to the program); EASTERLY, supra note 53, at 68 (pointing out after repeated doses of shock therapy, otherwise known as structural adjustment loans under austere conditions, the economic performance of the recipient countries did not improve).
97 EASTERLY, supra note 53, at 6-7.
98 Several examples exist of how the Asian Miracles combined various policy instruments for success. The lesson from their stories is not that one should copy them but rather the need for a mélange of various policy instruments from education to demographics to labor. See Paul Morris, Asia’s Four Little Tigers: A Comparison of the Role of Education
4. The Developmental Post Conflict State

It is apparent from our discussion so far that the needs of post conflict transition countries for transforming their economies into sustainable growth and development point to the choice of adopting the role of the “developmental state.” First, post conflict transition countries are afflicted with several severe market failures and constraints on their economies that cannot easily be resolved by reliance on pure neo-liberal, anti-state market driven policies. They need a pragmatic, developmental, “activist” or “interventionist” state with the right industrial policy framework. Second, it is also clear that conventional FDI and its system of interconnected operations as currently configured is unlikely to be a meaningful instrument for economic development in these countries. Most of them are suppliers of raw materials within the MNE system which does not create any beneficial links with the local economy. Notwithstanding these facts, MNEs have the capital, technology, know-how and other resources essential for economic development. These resources can be harnessed and channeled to that end by the State. Third, the evidence from countries that have made a meaningful and sustained transition towards industrialization suggests models and pathways to development that can inform the choices to be made by post conflict transition countries. The success stories have demonstrated that the “developmental state” can, through ingenuity, craft a complex and deliberate commingled policy design that relies substantially on domestic investment demand and local physical and

in their Development, 32 COMPARATIVE EDUCATION 95 (1996); Eva Mueller, The Impact of Demographic Factors on Economic Development in Taiwan, 3 POPULATION & DEV. REV. 1 (1977); Frederic C. Deyo, Labor and Development in East Asia, 505 ANNALS AMER. ACADEMY POL & SOCIAL SCIENCE 152 (1989). 99 UNCTAD, ECONOMIC DEVELOPMENT IN AFRICA: RECLAIMING POLICY SPACE at 58, U.N. Doc. UNCTAD/ALDC/AFRICA/2007/1, U.N. Sales No. E.07.II.D.12 (2007) [hereinafter UNCTAD, RECLAIMING POLICY SPACE]. 100 See Dani Rodrik, Getting Interventions Right: How South Korea and Taiwan Grew Rich. GROWTH POLICY, April 1995 (arguing that the growth in South Korea and Taiwan was a result of subsidized and coordinated investment decisions and government policy engineering to increase private capital); Samuel P. S. Ho, Economics, Economic Bureaucracy, and Taiwan’s Economic Development, 60 PACIFIC AFFAIRS 226 (1987) (examining the complexities of the institutional, political and administrative interrelationships in development and the successful role of the economic bureaucracy in the development of Taiwan.); Kevin Grice & David Drakakis-Smith, The Role of the State in Shaping Development: Two Decades of Growth in Singapore, 10 TRANSACTIONS INSTITUTE BRITISH GEOGRAPHERS 347 (1985) (discussing how the social and economic development of Singapore has been carefully shaped by the state to ensure national prosperity; nothing seems to have been left to chance); Yung Chul Park, Development Lessons from Asia: The Role of Government in South Korea and Taiwan, 80 AMER. CON. REV. 118 (1990) (arguing that the governments in both South Korea and Taiwan played an active role in the export-led growth of their economies); SOUTH ASIA IN THE WORLD (Ramesh Thakur & Oddny Wiggen eds., 2004) (a collection of several conference papers covering a wide range of topics ranging from security to development policy for the region).
human capital accumulation for the manufacture of products aimed at external markets.

The task of the “developmental state” is to focus on the answer to the critical question, what is the meaning and purpose of development? According to Amartya Sen, winner of the Nobel Prize in Economics in 1998, ancient religious and philosophical texts have struggled with the purpose of wealth. According to him, Aristotle saw wealth merely as an instrument for something else. Similarly, the industrial policy architecture of the “developmental state” might be aimed at a chain of purposes: the empowerment of the economy which in turn empowers people towards self-fulfillment and liberty. Thus, industrial policy is ultimately not about growth indices as such but about economic, social and cultural enrichment of individual citizens for the expression of their liberty. Indeed, for all its brilliance, Hernando De Soto’s celebrated book *The Mystery of Capital* about unlocking the vast amounts of the invisible capital of the poor has, at its core, the purpose of the enlightenment of the poor to transform their vast unstructured wealth towards self realization.

In view of the foregoing, the goal of this section is to develop, or at least to suggest, an industrial strategic architecture for a developmental state that benefits from the positive elements of successful countries, while taking into account the conditions of the post conflict transition countries. Such a strategic architecture will draw on the positive contributions of foreign investors outside of the framework of conventional FDI. It will seek the contributions of capital, technology, know-how and other resources generally generated and bundled in FDI, while avoiding the attributes of permanent ownership and control of conventional FDI as well as their cost. As a general policy, the industrial strategic architecture contemplated will insist on investment activities that create meaningful links with the local economies. This will require, as its primary focus, the elimination of the export of raw materials without some local processing. Put more directly, as a general policy, *post conflict transition countries with abundant natural resources must resolve never to export those resources in their raw form.* Such a policy will be perhaps the single most important policy decision made. It will establish a major paradigm shift, the acquisition of a mindset that demonstrates the belief and willingness of the country to alter its position permanently in the global commodities regime. It will at once constitute an immediate break with the past and compel the adoption of several necessary and complementary policies essential to local value added and economic development in general. The feasibility, sequencing and intensity of the required productive activities will be a matter of policy, based on the nature of the resources in each country.

The strategic policy architecture must take into account the mineral and natural resources of the country. However, the industrial policy prescription for

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102 Id. at 14.
103 HERNANDO DE SOTO, THE MYSTERY OF CAPITAL (2000) (explaining that capitalism has not worked in poor countries not because of the lack of capital but the invisible and unstructured way in which capital exists that makes it impossible to harness its greatest potential for development).
transforming post conflict transition countries must go beyond the processing of raw materials and reducing the vulnerabilities associated with them. The strategic architecture must include policies for industrial upgrading involving other sectors and industries, with a view to value-added investment activities. According to John Dunning, a country should improve upon any processes it does well, in addition to venturing into other sectors that hold promise for industrial upgrading.\(^\text{104}\) In particular, consideration might be given to investments in what has been described as flexible factories for the manufacture of standardized products or manufacture-to-order operations for spare parts, clothing and similar operations in services.\(^\text{105}\) The current wave of outsourcing globally captures this phenomenon. Independent factories not committed to the continuous process of the manufacture and sale of specific products provides the factory involved with great flexibility and a great opportunity for sharing its fixed costs with its customers.\(^\text{106}\)

However, a manufactured-export led industrial strategy necessarily demands the achievement of a second goal in the design of industrial policy. That is, the recognition of the important and inevitable link between trade and investment policies to export-led growth and development.\(^\text{107}\) The evidence from the Asian Tigers demonstrates clearly that a successful export-oriented industrial policy had to address three crucial elements: (1) the demand side of the equation: which products to manufacture and for which markets; (2) the essential elements of global competitiveness for those products: (high quality, low cost and low price); and (3) the issue of market access. Policy makers understood that globally competitive products needed a free trade regime that assured market access to target markets.\(^\text{108}\) The achievement of these goals was a collective effort of government officials in the relevant ministries and trade negotiators and entrepreneurs, particularly industry leaders. For instance, working within the framework of the gaps and ambiguities in GATT and employing tactical “bilateral/unilateral” voluntary export restraints, Japan was able to gain and retain market access to some high per capita income markets such as the U.S. for its high demand export products in the 1970s and 1980s.\(^\text{109}\)


\(^{106}\) Yelpaala, Global Product Distribution, supra note 67, at __.

\(^{107}\) See, e.g., Manuel R. Agosin & Francisco J. Prieto, Trade and Foreign Direct Investment Policies: Pieces of a New Strategic Approach to Development, 2 TRANSNATIONAL COPR. 63, 68 (1993) (advocating linkages between trade and foreign investment policies for effectiveness); Terry Ursacki & Ilan Vertinsky, Long-Term Changes in Korea’s International Trade and Investment, PACIFIC AFFIRS, 385 (200…);

\(^{108}\) See, e.g., SAKONG, supra note 5; Sung Yeung Kwack, supra note 5; Scitovsky, supra note 5.

\(^{109}\) Andreas Lowenfeld has provided an interesting discussion of the evolution of “voluntary restraints agreements” dating back to the late 1960s when the U.S Congress initiated a series of Bills (at least 22) aimed at imposing quotas and limits on the
The third goal of the industrial strategic architecture for the developmental state is self-reliance. Ultimately, the transformation of the economies of post conflict transition countries must be in the hands of locals who are most familiar with their needs and the complexities of welding together competing forces into a coherent whole for the national good. Foreign planners, advisors and other well wishers can assist but cannot do it for them. From Japan to South Korea and more recently from India to China the evidence is mounting that the development task is “homegrown.” It requires the building of foundational institutions and adopting fundamentally sound macroeconomic policies. The concept of self reliance might seem counterintuitive in the case of countries that are just emerging from severe conflict but the experience of Vietnam and Rwanda might contradict that. With the right framework and mindset much is achievable, even in post conflict states.

Fourth, and more specifically, it is clear from our discussion of the success stories that the economic fate of post conflict transition countries cannot be left totally in the hands of the free-market forces under the type of neo-liberal policies that dominated the decades of the 1980s and 1990s. Nor can the transformation of these countries be purely the function of the interventionist and activist state. In the post conflict transition state, either of these approaches in isolation will be an unmitigated disaster. The severity of market failure and the potentiality of excessive political power that normally befalls post conflict countries do not bode well for an either or policy framework. What is required is the “developmental state” that designs its industrial policy drawing from a combination of sources. Under its guiding hand, private investments play the primary role in investment activities targeted towards certain industries and manufactured exports with the greatest potential on development, while the government simultaneously engages in infrastructural development and various forms of regulation of industry suited to the task at hand.

Finally, it is clear from our discussion so far that the “developmental state” does not believe in unfettered or unregulated access to its productive resources with the greatest potential for generating growth and development. The same approach was taken by the East Asian Miracles towards FDI. Through different policies and regulations, South Korea and Taiwan channeled FDI towards importation of foreign steel products into the U.S. To forestall such legislation, which is often difficult to repeal, Mr. Yoshihiro Inayama, the Chairman of the Japan Iron and Steel Exports’ Association, went to the Washington D.C. for talks with the U.S Department of State proposing import restraints to be imposed by the Japanese exporters. For a full discussion of that history and the legal issues the followed see, ANDREAS F. LOWENFELD, PUBLIC CONTROLS ON INTERNATIONAL TRADE VI 195-252 (1983); Comment, Executive Authority and Antitrust Considerations in “Voluntary” Limits on Steel Imports, 118 U. Pa. L. REV. 105 (1969). The technique of using voluntary restraints by Japanese industries also came to a head in the semiconductor industry, resulting in the Semiconductor Accord of 1986. See Dorinda G. Dallmeyer, The United States-Japan Semiconductor Accord of 1986: The Shortcomings of High-Tech Protectionism, 13 MD L. INT’L & TRADE 179 (1989); Diane P. Wood, ‘Unfair’ Trade Injury: A Competition-Based Approach, 41 STAN. L. REV. 1153 (1989) (arguing that there is no reason for consumers to be deprived of low-priced products through the use of trade restraints).

110 EASTERY, supra note 53, at 6.
industries where their contribution would advance some national objectives. In certain industries foreign investors were permitted only as equal or minority joint venture partners with local enterprises.\footnote{Urban C. Lehner, \textit{Breakup of Dow Chemical's Joint Venture with Koreans Leaves Both Sides Unhappy}, \textbf{Wall St. J.}, Jan. 5, 1983.} In the case of Japan, there appeared to be a preference for the acquisition of foreign technology instead of FDI. The most recent example of the “developmental state” at work is China.\footnote{UNCTAD, \textit{Reclaiming Policy Space}, supra note 99, at __.} It is fair to say that the foreign investment laws of China do not encourage unfettered or unregulated FDI in all industries.\footnote{Yelpaala, \textit{Model Investment Law}, supra note 12, at 45; Yabo Lin, \textit{New Forms and Organizational Structures of Foreign Investment in China Under the Company Law of the PRC}, \textbf{7 TRANSNAT’L LAWYER} 327 (1994).} The foreign investment laws distinguish between the more desirable high technology investments and others for differential treatment.\footnote{Lin, \textit{supra} note 113, at __.}

It is apparent from this discussion that the policy response to FDI was not hostility but one geared towards harnessing its positive effects and contributions to the local economies. Where FDI could make a difference it was not left to its own devices to make the needed contribution. Rather, foreign investors were prodded, guided or channeled towards certain industries or projects. If this was the context within which FDI operated beneficially under much more favorable circumstances, the question presented here is whether FDI could produce similar beneficial consequences under less hospitable circumstances and without guidance in post conflict transition countries. The answer to this question will be pursued in below.

\section*{VII. THE ROLE OF PROJECT FINANCE IN INDUSTRIAL POLICY IMPLEMENTATION}

The argument advanced so far is that if the goal of any strategic industrial policy architecture of a post conflict transition country is the transformation of its economy conventional FDI is the unlikely candidate for that task. Burdened by severe economic constraints and endemic uncertainties compounded by ever looming risks, post conflict transition countries are hardly attractive to the type of high value FDI that could transform a country. The foreign investment opportunities that tend to attract MNEs to those countries are mostly in enclave and natural resource activities with minimal developmental impact. Enclave investments in abundant natural resource countries might even infect them with the so-called “Dutch Disease.”\footnote{KREMERS, \textit{supra} note 49, at 96-136. (discussing the term “Dutch Disease” in explaining the internal economic stresses the Dutch economy experienced in the 1960s and 1970s as result of the development of its natural gas reserves); ECA, \textit{Managing Mineral Wealth}, supra note 49, at 22-25, 37(discussing the Dutch Disease problems within the mineral regimes of Africa).} Yet in the midst of this disappointing picture the opportunities for high value transformative foreign investment abound only if a different type of investor and investment opportunities are sought after. The
investment instruments that hold great promise for transforming these countries is project finance or a variation of it generally referred to as “build operate and transfer” (BOT). The self reliance industrial policy framework advocated in this study could benefit from project finance projects that result in an eventual transfer of the projects to local interests. Although BOTs are generally analyzed under the framework of project finance for the purposes of emphasis and clarity in policy implementation we shall examine them separately below.

1. Project Finance

Project finance is a tried and true old-fashioned medieval merchant banking investment practice that seems to have escaped the attention of foreign investment theorists. As an investment instrument, project finance is a non-recourse or limited recourse financing scheme used by private investors to fund specific projects or ventures solely on the basis of the ability of the projects to pay for themselves from their cash flow.\(^\text{116}\) The sponsor of the project does not guarantee repayment of the principal and interest should the project fail to produce sufficient proceeds to service the debt. In that sense, the financing is a non-recourse funding in which the lenders, creditors and equity investors do not look to the general assets of the sponsor for repayment of the loan. In the case of limited recourse financing the lenders look to the assets of the sponsors for a repayment of a portion of the debt. As is generally the case, most interesting investment schemes with great potential for profitability are unlikely to be totally new in the history of business. It is therefore not surprising that project finance has ancient roots. In an insightful article John Kesinger and John Martin traced the origins of non-recourse project finance to medieval Florentine merchant banking practices.\(^\text{117}\) Apparently, as early as 1299 the English Crown raised funds from Frescobaldi, a leading Florentine merchant bank based on a contract of repayment solely from the output of the Devon silver mines.\(^\text{118}\)


\(^{118}\) Kensinger & Martin, Raising Money the Old-Fashioned Way, supra note 105, at 72; Jean Gimbel, The Medieval Machine 73-74 (1976) (in a chapter devoted to mining the mineral wealth of Europe, the author explains that one of reasons why the Frescobaldi, Florentine financiers were willing to advance the English Crown money in return for the
This ancient venture-by-venture financing technique has remained prominent throughout the days of trading expeditions and voyages until the emergence of the joint-stock companies of the 17th century. In fact, it would appear that daring voyages of explorations chartered by European Princes and undertaken by Vasco Da Gama and Bartholomew Diaz along the west coast of Africa to the Cape of Good Hope in South Africa had that character to them. Indeed, the Dutch East Indian Co. and its counterpart the British East Indian Co relied on this venture-by-venture method of funding trading expeditions and voyages in their early days. At the end of each voyage, the accounts were settled and investors were paid. This gave investors the freedom either to roll-over their investments or to participate in new ventures purely on the basis of their promise for reasonable returns on capital. Even with the advantages of permanent capital associated with the rise of the modern limited liability company, some investors have continued to prefer the flexibilities inherent in project-by-project investment instruments. They do not want their capital locked up permanently in the hands of corporate managers. And, this is good news for creative policy makers seeking transformative capital investments.

It is therefore not surprising that Kesinger and Martin have pointed out that non-recourse project finance did not disappear even with the emergence of the modern corporation. Indeed, project finance has not only made a remarkable comeback in modern times but also seems to hold significant implications for the future of funding projects particularly in risky poor countries. After all, the trading expeditions and voyages financed by investors were risky ventures to say the least. Project finance is now employed by developed and developing countries in a variety of projects ranging from infrastructure, power generation, oil and gas and mineral explorations and exploitation, orbiting communication satellites to manufacturing and research and development. However, the modern proliferation of project finance seem to be a phenomenon concentrated most in developed countries, Asia and Latin America. Naturally, the return of project finance has also produced a growing body of literature addressing its various complexities as an investment instrument which cannot be explored here.

revenue from the silver mine leased to them was the fact that cash flow from the mines doubled).

Kensinger & Martin, Raising Money the Old-Fashioned Way, supra note 105, at 72-73.

Id. at 70; IFC, PROJECT FINANCE IN DEVELOPING COUNTRIES 18 (1999) (hereinafter IFC, PROJECT FINANCE) (providing a distribution of project finance by category).

IFC, PROJECT FINANCE, supra note 121; LARRY H. P. LANG, PROJECT FINANCE IN ASIA (1998) (hereinafter LANG, PROJECT FINANCE IN ASIA) (providing a study and analysis of project finance its adaptive configurations in “New Asia”)

However, what potentialities non-recourse project finance holds for the future should be of great importance to post conflict transition countries seeking investment for risky but transformative ventures. Conventional FDI with its emphasis on permanent capital and its commitment to continuous processes of manufacturing specific product lines marketed under a unified brand name may not always be ideal for projects in developing countries that do not fit into that framework. For developing countries in general and post conflict transition countries in particular this technique of funding projects could be converted to their development objectives to great effects.

One may ask why project finance provides opportunities for the transformation of post conflict transition countries. We shall endeavor to investigate this question by focusing on the nature and structure of the typical project finance as captured in Diagram 2 below:

As is apparent in Diagram 2, the typical project finance transaction will involve at least six primary parties and the project company through which the assets of the project are managed in a separate and independent legal entity. Critical to any project finance transaction are the sponsors who undertake to raise


the necessary capital for the project from banks and other lenders. Depending on
the nature of the risk in the project, the sponsor may be required to make equity
contribution in the range of 15% to 30% of total cost.\(^1\) Thus, instead of
conventional FDI, the project is funded by a substantial amount of debt and small
equity investment. In this Diagram, the sponsors will make the equity
contribution through an equity joint venture. The non-recourse debt is made by a
syndicate of banks and multilateral and bilateral institutions. However, given
that the project concept is derived from and driven by government industrial
policy emphasizing local processing the host government is an indispensable
party to the transaction. The three other parties include input suppliers to the
Project Company, output purchasers who buy the products through various
contractual arrangements and the contractor responsible for building the plant.

In our earlier discussion of the MNE system we argued that the rise of the
MNE was in part to address the failure of the law of contracts in open market
transactions and to minimize the transaction costs associated with the
misalignment of contractual obligations. An internal MNE contracting system
operating within a vertical and horizontal integration structure is maintained by
fiat thereby elimination the open market contract problems. In the case of project
finance the entire structure is constructed and maintained largely by a heavy
reliance on the open market model. Indeed, the modern project fiancé is a nexus
of complex interconnected contractual relations between host governments,
sponsors, bankers, suppliers of inputs and purchasers of outputs. The success of a
project finance venture and the eventual repayment of the debt depends on how
well the series of interconnected contractual obligations assign and minimize the
risks and costs associated with the misalignments in the contracts. Given the non-
recourse or limited recourse nature of the financing involved, the materialization
of certain significant risks would jeopardize cash flow and repayment
obligations. Although the project might have been generated or directed by
government industrial policy its implementation is not the responsibility of the
government but driven and guided by open market forces. This leaves the success
of the project in the hands of private entrepreneurs who have something serious
at stake in it.

Thus, in its modern reconfiguration of non-recourse or limited recourse form,
project finance offers several opportunities for economic development. The fact
that funding is based on a project-by-project basis lends itself to the
implementation of an industrial policy based on targeting industries and projects
with the greatest potential for economic development. With the government on
the sidelines, the private parties with limited recourse, non-resource or equity
capital exposure in the project have every reason to work for its success.
Concerns expressed in the decades of the 1970s over the cost and benefits of FDI
led to arguments for a dynamic screening process for FDI with the best potential
for development at the least cost.\(^2\) Over two decades later the issues of cost and
benefits of FDI have reemerged and screening for the most developmentally
sound projects through a strategic industrial policy architecture continues to be

\(^1\) LANG, PROJECT FINANCE IN ASIA, supra note 122, at 11; HOFFMAN, supra note 116, at
5.
\(^2\) Yelpala, Cost and Benefits of FDI, supra note 8.
relevant. With target industries and projects identified, the governments can undertake feasibility studies or solicit them from potential sponsors. Qualifying projects have certain attractiveness to both the sponsor and the government. Since the projects are selected on the basis of their potential contribution to the industrial policy objectives of the host country there is little risk that there will be no positive developmental impact on the country. From the point of view of the sponsor and lenders the fact that the projects must pay for themselves makes them less financially risky. Thus, project finance presents opportunities for a win-win investment relationships which otherwise would not exist.

2. Impact of Project Finance on Industrial Policy Objectives

From its inception to its current modern configurations project finance has continued to offer several benefits to foreign investors and host governments that permanent capital in the form FDI does not easily provide. The benefits and advantages examined below should also engage the attention of policy makers in post conflict transition countries.

From the point of view of the equity investors, project finance provides sponsors with financial independence on a project-by-project basis and insulates their general assets from the financial obligations associated with the loan for the project. This is often referred to as “off-balance-sheet” debt since the project finance debt does not show up in the consolidated financial statements of the sponsor. This permits the sponsor to maintain a certain debt/equity ratio and not to dilute its existing equity. Even when the project finance is on a limited recourse basis the commitments of the sponsor are still substantially less than full recourse obligations. For host governments risky and complex ventures with developmental potential can be funded and implemented.

The cost of the typical complex project finance transaction runs from the tens of millions to billions of dollars. For example, while the cost of the Nghe An Tate & Lyle Sugar Mill in Vietnam was $90 million the cost of the Australian-Japan Cable project stood at $520 million and that of the Chad-Cameroon Pipe Line was $4 billion. The financial demands of these projects expose lenders to such high risks that no single lender was willing to undertake them alone. The funding of projects is therefore generally undertaken by a multiplicity of parties: banks, equity investors and multilateral institutions to spread the risks associated with each project among multiple parties. Risk distribution works to the benefit

128 HOFFMAN, supra note 116, at 9.
129 Id. at 10.
130 ESTY, supra note 116 (providing a case study of different projects and their related costs; Chad-Cameroon Pipe Line at 71; Australian-Japan Cable Project at 93; Nghe An Tate & Lyle Sugar Company at 190).
131 IFC, PROJECT FINANCE, supra note 121 at 8.
of host developing countries since it allows more deserving projects to be funded at a lower cost to the participants and governments.\textsuperscript{132} Besides, the parties can participate in multiple projects without risking huge amounts of capital in any of them. Conventional FDI, even within its risk sharing joint venture format, is unlikely to commit such huge amounts of permanent equity to these ventures in risky countries.

Moreover, the demands of project finance are fairly rigorous. As an IFC report aptly stated, there is no free lunch in project finance.\textsuperscript{133} Since each project must stand on its own and pay for itself the selection process is guided by careful capital budgeting techniques. Qualifying projects must then meet basic corporate capital budgeting requirements in terms of their cash flow and the ability to pay for them selves. Although objections might be raised about the government picking winners one ought to keep in mind that this process compels the host government to pick wisely and therefore brings some discipline in any policy of industrial targeting used by the government.

For countries with abundant natural resources, manufacturing based project finance confronts directly the enclave characteristics of conventional FDI lamented by the World Bank and other international institutions.\textsuperscript{134} If, as we have argued, no resources may be exported without local processing, project finance provides several advantages in that regard. Establishing a local processing plant would bring about the infusion of capital, technology and know-how, the very assets and contributions generally sought after in conventional FDI. With project finance, the host country receives those resources and benefits in the industries and projects that matter to its industrial development goals, the achievement of which is not guaranteed by conventional FDI. Moreover, local processing does not only provide value-added contribution to local resources but also creates linkages with the local economy generally considered as essential for development. Besides, conventional FDI in natural resources may create a perverse effect on supplier countries. It may expose them to vulnerability dependence created by the volatility of global commodity markets on which they have to rely.

The growth rates and economic fortunes of mono-crop economies or those heavily dependent on one or two commodities traded in the world commodities markets are dictated by forces outside their control. Their growth rates rise and fall with the swings in world commodity market prices. Such is the current experience of many African countries that seem to be enjoying high GDP growth rates mainly because of current favorable commodity prices.\textsuperscript{135} However, with local processing the growth rates of post conflict transition countries will be

\textsuperscript{132} Id.
\textsuperscript{133} Id; Stefanie Kleimeier & William L. Megginson, A Comparison of Project Finance in Asia and the West, in LANG, PROJECT FINANCE IN ASIA supra note 122, at 68.
\textsuperscript{134} WORLD BANK, GLOBAL DEVELOPMENT FINANCE, supra note 96, at 97(arguing that FDI in natural resources create limited linkage effects, produce the Dutch Disease and make host countries susceptible to the volatility of world commodity prices).
\textsuperscript{135} INTERNATIONAL MONETARY FUND, REGIONAL ECONOMIC OUTLOOK, SUB-SAHARAN AFRICA (World Economic and Financial Surveys) (2007) at 4 (arguing that fragile economies such as Sierra Leone, Liberia, and the Democratic Republic of Congo are enjoying higher growth rates because of higher commodity prices).
stabilized over time. Consider what the economic fate of Angola and the DRC would be if these countries employed the strategy of compelling or at least insisting on local processing of their raw materials. The crude oil of Angola would be refined before export so would the numerous ores and minerals of the DRC. Producers of coffee beans such as Rwanda would, through project finance, establish flexible coffee roasting facilities with the capacity to roast coffee beans to the specifications of any foreign buyer. Over time countries such as Rwanda, Ethiopia and Kenya could develop their own national brands of roasted coffee for the global market place.

The point that ought to be stressed here is the need to redirect national policy towards new empowering possibilities for developing countries. The limitations on local processing in poor countries may be more an issue of limited imagination and generalizations than one of limited human capacity in specific cases. For instance, in 1998, Mozambique, one of the least developed countries in the world, with the assistance of IFC obtained project finance funding of $1.2 billion for a green field investment in an aluminum smelter called MOZAL. This project was the largest private sector project in the country. Kaiser Aluminum has since the 1960s operated an aluminum processing plant in Ghana using imported bauxite and initially imported technical labor. Neither of these two countries could be said to have had the requisite supply of labor at the outset. The possibilities and feasibility of local processing was assessed against the backdrop of the global supply of human capital and other resources in the short term and the necessary long term adjustments.

Notwithstanding the arguments made in the immediately preceding section, the labor policies in an industrial policy framework for local processing ought to be addressed separately. Local processing ultimately will require skilled local labor in the form of engineers and technicians if the benefits of know-how transfer are to be realized. In the typical post conflict transition country such skilled labor may be absent either because of inappropriate educational programs or from brain drain. Both of these can be addressed in the short and long term. Initially, the productivity of the local processing plant can be handled by hiring foreign skilled labor. The world offers an almost inexhaustible pool of skilled labor force for the needs of any specific project in any country. However, the future needs of the processing plant must be addressed through a deliberate training program the cost of which is incorporated in the cost of the project. In other words, built into the project cost must be the training of a pool of local engineers and skilled labor to replace the foreign technical work force in the long run. The sponsor must undertake to implement this program with yearly targets for an agreed upon number of years. Thus, at the end of that period the size of the technical labor necessary for efficient operations would have been substantially satisfied.

What is perhaps even more important to the policy requiring local processing is its impact on other government policies if the entire industrial policy can be beneficially implemented. This single policy should trigger complementary policy changes in education, banking, investments, commercial laws, public

136 IFC, PROJECT FINANCE, supra note 121, at 2.
137 HART, supra note 68, at 59-64.
expenditures on infrastructure, macroeconomic management and others essential to the industrial development goals pursued.\textsuperscript{138} Thus, to ensure the continuous flow of technical labor force the general educational policies of the country will have to be adjusted and realigned. As discussed above, the East Asian Miracles focused on primary and secondary education to great effect not only in increasing labor productivity but also in closing the income inequality gap.\textsuperscript{139}

One of the benefits of local processing of raw materials for exports is the irrelevance of the constraints imposed by small, underdeveloped or inaccessible local markets. The target markets for the output are external hard currency global markets which are infinitely larger than the supply capacity of any single small country. The existence of these markets should not be in question since they are the same markets that foreign raw materials processing plants aim to serve. The real issue will be global the competitiveness of the output with respect to quality, cost and price. But under project finance the project would most likely not be funded if these requirements were not met. However, a well constructed link between trade, investment and industrial policy should ensure market access.\textsuperscript{140} At least, the policy of local processing of raw materials for export compels a comprehensive, coherent and integrated policy framework that ties all the pieces together. \textit{There are neither half measures nor free lunches in the development game.}

3. Industrial Upgrading of Light Manufacturing Industries and other sectors

The emphasis on local processing of raw materials for export should not be read as a limited policy prescription. Rather it is to stress the need for a \textit{paradigm shift} in the policy orientation of developing countries in general and post conflict transition countries in particular. After all, the possibilities for industrial upgrading even in countries with abundant natural resources extend beyond those resources. And, several countries are not endowed with abundant natural resources. The general argument we seek to make is that industrial policy should be aimed at empowering the local productive forces through value-added industrial upgrading investment activities in sectors with the greatest promise for growth and development. Such empowerment may focus on exploiting the comparative advantage of the country together with whatever opportunities the global economic resources may offer.

\textsuperscript{138} A comprehensive approach to industrial policy complemented by industrial legislation appears to be the approach used by the East Asian Miracles. \textit{See} SAKONG, \textit{supra} note 5; Yelpaala, \textit{Model Investment Law, supra} note 12, at…(discussing the nature of industrial legislation within the framework of industrial policy).

\textsuperscript{139} \textit{Page, supra} note 7, at 227-229, 234, 264.

\textsuperscript{140} \textit{See}, Manuel R. Agosin and Francisco J. Prieto, \textit{Trade and Foreign Direct Investment Policies: Pieces of a New Strategic Approach to Development?} TRANSNATIONAL CORPORATIONS 63 (1993)(discussing the important link between trade and foreign direct investment to development.)
Project finance can be employed fruitfully in establishing manufacturing facilities for the production of generic or standardized global products such as spare parts, component parts, original equipment manufactured products, bottles and soda cans that be used by many soft drinks manufacturers. In the high technology sector, data processing and related computer based service centers offer yet other opportunities for servicing multiple clients within the current global outsourcing regime. Factories with multiple output capacities have been aptly described as flexible, independent or batch-process in that the manufacturer neither owns the products nor is it producing a single line of products tied to a brand name or logo.\textsuperscript{141} The use of project finance under these circumstances provides the manufacturer with great flexibility in managing its risks and maintaining stable profits. Flexible factories are capable of producing different types of unbranded or branded products for different foreign customers. Such is the case of manufacture-to-order facilities that produce different brand name designer clothing or customized goods or components for different customers. The manufacturer is not unlike the typical village blacksmith of yesteryear who made different wares and products on order for different customers.\textsuperscript{142}

For post conflict transition countries, the batch-process manufacturing plant offers several advantages for industrial upgrading. As already pointed out above, the manufacture of goods destined for foreign customers and markets minimizes or removes the domestic and regional market constraints faced by these countries. As an independent manufacturer of different products under contract for different customers, the manufacturer retains great flexibility for profitable operations. The cash flow of the manufacturer that is so essential for project finance is not linked to a single product or market of the manufacturer but determined by a variety of its manufactured products marketed by its customers globally. The manufacturer is to a large extent insulated from the consequences of competition between its customers for global market share. Losses and gains in market share by its customers may result in a loss of some customers but they do not necessarily change its production volume and the resulting cash flow.\textsuperscript{143}

Project finance of flexible factories or production services open up other possibilities for a host country in the area of strategic alliances. It is now clear that one of the goals of the strategic alliances of 1980s was the search by enterprises for opportunities to convert their fixed cost into variable cost by sharing them with as many partners as possible. Flexible manufacturing facilities fit into this mold. Through them many competitors save money by not building their own plants and without investing any money in the manufacturer share its fixed cost by contractual arrangements. These arrangements permit economies of scale, lower per unit cost and better global price competitiveness.

The impact of project finance on independent value-added manufacturing facilities would produce effects similar to those gained from the processing of local raw materials. The investment would involve the transfer of capital, technology, know-how and create linkages with the local economies. Of course, the efficacy of this policy would depend critically on the availability of skilled

\textsuperscript{141} Kensinger & Martin, \textit{Raising Money the Old-Fashioned Way}, supra note 105, at 81.
\textsuperscript{142} \textit{Id.} at 81.
\textsuperscript{143} \textit{Id.} at 74.
labor, the productivity of labor, output quality and cost. The response to these issues has already been discussed above. Similarly, the efficacy of independent export oriented factories would depend on a well coordinated investment and trade policies also discussed above.

In conclusion, the search for transformative policies and investment strategies in post conflict transition countries must start with not only what the domestic economy offers but even more so on what the global economic environment offers in terms of capital, technology, other resources and markets. In the short term, the picture may be dim but policy makers should focus on laying the foundations for sustained future growth and development. With project finance, some of the short term and long term constraints can be addressed by utilizing available global resources to empower local industries to be self-reliant in the long term.

VIII. THE USE OF BUILD OPERATE TRANSFER INDUSTRIAL POLICY IMPLEMENTATION

One of the key elements to the strategic industrial policy architecture advocated for post conflict transition countries is the use of self-reliant economic development policies. We argued that in the ultimate outsiders no matter how well intentioned cannot transform those economies. They neither have much directly at stake nor are they in the best position to assess the complexities of the local conditions and make the most critical choices necessary. The locals are better suited for that job and can carry that out effectively if given the proper support. We have argued that such support can be given within the framework of project finance funding of private sector projects that hold the greatest promise for growth and development. As part of that empowerment we now argue that the project finance model should be build-operate-transfer (BOT) in which projects are transferred to local owners after a specified term.

The term BOT is said to have been the brain child of Turgut Ozal, Prime Minister of Turkey who coined the term in 1984 during the privatization of Turkish public projects. Soon after its introduction, the concept caught the imagination of governments in Europe, Asia and elsewhere seeking funding for various infrastructural projects at the time of severe fiscal constraints. The BOT approach became an attractive instrument for funding infrastructural projects.

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144 Easterly, supra note 53, at 26-33.
145 Mark Augenblick & B. Scott Custer, Build, Operate, and Transfer (“BOT”) Approach to Infrastructure Projects in Developing Countries 2 (World Bank Working Papers, WPS 498, 1990). The BOT concept has several variations to the theme. For instance some may come as “BOOT” (build, own, operate and transfer), “BOO” (build, own and operate), “BRT” (build, rent and transfer), “BOOST” (build, own, operate subsidize and transfer), and “BTO” (build, transfer and operate). Paul Handley, A Critical View of the Build-Operate-Transfer Privatisation Process in Asia, 19 ASIA J. PUB. ADMIN. 203, 213 (1997).
such as power generation plants, toll roads and tunnels such as the Eurotunnel. For policy makers, it made sense to invite foreign capital for the construction and management of basic infrastructural projects and have them transferred to the host government after the projects had paid for themselves. The attractiveness of the eventual transfer of an efficient and effective operating facility to local owners is one of the reasons why the BOT model is advocated here for the private sector in post conflict transition countries.

Under the BOT approach, one or more private sector sponsors are authorized to create a private project company to build a manufacturing plant or other facility using the project finance system to raise the necessary capital for the project. Under an agreement, the sponsors will build, manage, operate and maintain the facility throughout the project company as a separate and distinct legal entity for a specified time period after which the plant is transferred to local owners. The duration of time given to the sponsors to manage and operate the plant will vary with the size of the debt, the risks associated with the venture and its projected cash flow. BOT projects vary in characteristics, sectoral conditions, risks and costs. No two BOT projects are exactly the same. With non-recourse or limited recourse lending based on the notion that each project must pay for itself, the duration of the contract for the transfer to local ownership must reflect the risks and conditions of each project. In other words, the duration must reflect how long it would take for each project to pay for itself and provide the equity investors with a reasonable return. The BOT technique has two short and long term policy elements. In the short term it can be used to jumpstart an industry and in the long term to develop successful local entrepreneurial skills.

Just as project finance has ancient roots, the underlining conceptual framework of BOTs is also traceable to 18th century French concessionized infrastructural projects financing scheme used to develop the French water system. Thus, the BOT approach shares the same attributes and characteristics with the typical project finance analyzed above. However, the BOT model shares essential characteristics with production sharing agreements and service contracts that emerged in the 1960s in the oil and gas industry. Under these agreements,

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146 Handley, supra note 145; LANG, PROJECT FINANCE IN ASIA, supra note 122, at 153; ESTY, supra note 116 (discussing various case studies of infrastructural power plants and other projects including the Eurotunnel).

147 Handley, supra note 145, at 212-213 (explaining the duration of BOT projects: power generation, 10-20 years, toll roads, 20-30 years and the Eurotunnel, 55 years).

148 Id. at 212; CHARLES T. WALKER & ADRIAN J. SMITH (Eds), PRIVATIZED INFRASTRUCTURE: THE BUILD OPERATE TRANSFER APPROACH (1995).

149 See SMITH & WELLS, THIRD WORLD MINERAL AGREEMENTS, supra note 76 (explaining in chapter two the structure and substance of mineral agreements including the production sharing and service contracts). For a comprehensive discussion of the history and the different phases through which mineral and petroleum and mining agreements moved, see UNCTC, TRENDS IN PETROLEUM AND MINING AGREEMENTS, supra note 76 (explaining the different techniques including renegotiations used to redistribute gains for trade and maintain stability). For an interesting discussion of the structure and renegotiation of production sharing agreements in Indonesia see Tengku N. Machmud, The Production Sharing Contract in Indonesia, in INTERNATIONAL OIL AND GAS INVESTMENT MOVING EASTWARD 113 (Thomas W. Waelde & George K. Ndi, eds., 1994)
foreign enterprises acting as independent contractors provided debt capital to host
governments for the exploration and exploitation of oil and gas which was paid
for in cash or in kind according to a set of complex contractual provisions.
Similarly, as part of the project finance schemes, BOTs constitute a series of
complex transactions and contractual relations involving multiple parties,
different resources, several phases and risks.

The purpose of this study is not to explore all the complexities of BOT
transactions and operations. Rather our goal is to focus on the issues that are
relevant to the use of BOTs as instruments of empowering local entrepreneurs for
economic development. Attractive as the BOT concept might be for developing
local entrepreneurs, it presents certain challenges for policy makers and
governments. The BOT structure, parties, contracting framework and risks are so
complex that success demands the utmost attention to how all the pieces of the
system of contracts fit together. The complexities inherent in the BOT framework
are best captured by Diagram 3 below.

In our earlier discussion of project finance we captured its basic structure in
Diagram 2. Diagram 3 draws on that basic structure of project finance and

(describing the phases of the Indonesian production sharing agreements and the reasons
for renegotiations). New forms of production sharing agreements seem to have
adjustments built into them, see generally Andrei Yakovlev, Production Sharing
Agreements in the Russian Petroleum Sector, 20 WORLD COMP. L. ECON. REV. 45 (1996)
(describing the nature and structure of production sharing under the Russian Production
Sharing legislation).
provides a much more detailed depiction of the parties and the series of contractual relations involved. However, our discussion of Diagram 3 shall focus only on issues that are relevant to the role of BOTs in industrial policy implementation. For the purposes of this study the following subjects will be addressed briefly: (1) the nature and BOT project, (2) the parties, (3) the central role of the law of contracts, (4) the risks and (5) the role of incentives for achieving the development objectives.

1. The Nature of the BOT Project

Implicit in the BOT structure captured in Diagram 3 is the relevance of the project itself to the developmental objectives of the host country. As discussed above, not every project is suitable for project finance generally or under the BOT model. To ensure the developmental impact and empowerment of local entrepreneurs, projects should be screened against the industrial strategic policy architecture. In this regards, projects may be identified by the host country before or after feasibility studies to determine their viability. Having selected the industries with the greatest potential for developmentally sound projects, the host country may also invite the private sector to submit BOT project proposals that meet its goals and objectives.

BOT projects selected under this scheme should satisfy three essential criteria. First, they must be financially viable in that they should generate a cash flow sufficient to service the debt. Second, they must advance some economic development goals of the host country. Third, each project must have the capacity for creating a sustainable local entrepreneurial class in the industry involved. The central theme of these arguments and the policy prescriptions suggested is that the impact of BOTs on the local economy cannot be left completely to chance.

2. The Parties

It is apparent from Diagram 3 that the typical BOT project involves a large number of direct parties and many more associated with different aspects of the project. The large number of parties presents certain strengths and weaknesses in BOTs. In the first place, given the non-recourse and limited recourse nature of funding involved, BOT projects are likely to receive greater scrutiny by different lenders and equity investors concerned about the risk of loss. As such, qualified projects would have a greater probability of success. For the host country, the greater the number of participants the greater the likelihood of getting the project funded since the risks will be shared by many as opposed to a single foreign investor.150

Risk sharing also benefits the participants since each of them will absorb only a small share of the financial and other burdens of the project. Lower levels of financial exposure and risks allow lenders, sponsors and others to participate

150 IFC, PROJECT FINANCE, supra note 121, at 8.
in multiple projects simultaneously. Besides, operating as a collective provides the parties with collective security against potential post contractual opportunism, threats of expropriation, nationalization or measures having equivalent effects.\textsuperscript{151} Measures of that nature that affect the interests of a syndicate of banks, other lenders, suppliers and equity investors in different industries from different countries and international financial institutions would visit significant, if not irreversible, detriment on the international interests of the host country. The cost to the host country would be too high for it to try.

Corruption continues to be a major problem in many countries and post conflict transition countries might be even more exposed to that phenomenon than others. However, the great number of participants in BOT projects might create a buffer to corruption by compelling greater transparency. The theory of cartels suggests that numbers are antithetical to cartel formation.\textsuperscript{152} That is, the greater the number of members the greater the difficulty of forming and maintaining a cartel. The same can said of BOT project participation. Corruption will be difficult to carry out when so many parties have so much at stake in the project. It would be difficult to pay off all or some government officials quietly for individual gains. The legal risks, costs and reputational damage associated with corruption under these circumstances might discourage the practice by the participants.

Notwithstanding these advantages the multiplicity of parties presents some difficulties in the implementation of BOT projects. One of the key elements to BOT transactions is the identification, assessment and distribution of risks among the parties. The greater the number of parties the greater the difficulty in distributing risks. Sponsors and others involved in these complex transactions might be able to conceal risks which in turn would increase agency or monitoring cost and the incidence of moral hazard.\textsuperscript{153} Moreover, the complexities of the transactions and the legal regime essential for their success might over task the legal capacity of the host country, particularly in the post conflict context. Thus, an essential element for the success of BOTs in post conflict transition countries would be legal reform that would facilitate the transactions consistent with their industrial policies.

\textsuperscript{152} See Katherine Maddox McElroy & John J. Siegfried, \textit{The Economics of Antitrust Enforcement}, in TERRY CALVANI \& JOHN SIEGFRIED, \textit{ECONOMIC ANALYSIS AND ANTITRUST LAW}, 139-140 (2d. 1988) (arguing that the fewer the number of firms in an industry, the simpler it would be for the firms to coordinate their actions and to agree upon common goals). Cartel theory argues that the incentives to cheat on one’s cartel partners increase as the number of firms increase and the stability of cartels decrease as a result such is the case of corruption. As the number of partners increase it will be difficult to collude quietly to corrupt government officials. \textit{Id.}
3. The BOT Contract

Central to the BOT transaction is the role of the law of contracts as an instrument for welding together different independent groups with different interests into a coherent system of contracts toward the common goal of a successful venture. An industrial strategic policy architecture that assigns a significant role to BOTs in its implementation must develop the appropriate legal environment for the enforcement of contractual obligations. A better understanding of the nature of the BOT contractual relations would be essential if the appropriate response is to be made. Although the BOT is mostly an open markets process it shares several characteristics with its counterpart, the firm, even as it seeks to operate outside the firm. In his seminal paper on “The Nature of the Firm” published in 1937, Coase argued that the reason why the firm emerged as an organization for internalizing all those transactions its owners could not rely on the open markets was to minimize transaction cost.154 Put differently, the firm was a response to market uncertainties and misalignments in open market contractual relations managed by the firm through integration. Having removed the necessity of dealing with independent third parties, internalization and integration permitted the owners to manage the internal relationships by fiat.155 This is seldom the case for post conflict transition countries. However, modern commentators argue that the firm is a nexus of contracts.156 In their view, in its attempt to avoid certain costly external markets transactions, the firm creates its own internal organization based on a nexus of contracts between the owners, managers, employees, suppliers, customers and others. As explained above, the internal dynamics of the nexus of contracts of the firm are governed by authority and fiat under a management command system. The firm sought to replace costly open market contracts with its own system of internal contracts.

In many respects the BOT transaction seems to mimic the firm by relying on a nexus of a series of contractual relations aimed at creating a system that allows it to minimize risks, reduce costs and receive the benefits of internalization without the cost of its authority structure or management by fiat. The preference for markets suggests a preference for party autonomy and contract management system based on mutuality of interests. Thus, the BOT approach would flourish within matured and stable contractual regimes. To the extent that the BOT approach is a policy choice, the market preference elements should be reinforced by reforming the legal framework in contracts for better results.

However, just as the firm suffers from agency cost so does the BOT transaction.157 In the modern firm with widely diffused ownership, the separation of ownership and control imposes a monitoring cost on owners concerned about

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155 WILLIAMSON, ECONOMIC INSTITUTIONS, supra note 58, at 78, 85; WILLIAMSON, MARKETS AND HIERARCHIES, supra note 58, at 106.
156 MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 135-139 (1998) (arguing that the firm is nexus of contracts written and unwritten among disparate individuals).
157 Farrell, Principal-Agency Risk, supra note 153.
managers pursuing interests other than those of the owners.\textsuperscript{158} According to Michael Jensen, one can identify three types of agency cost in the context of the firm.\textsuperscript{159} In spite of incentives for proper conduct by managers the owners must incur the cost of monitoring aberrant behavior of managers. As agents, managers also incur what is termed bonding cost in trying to give guarantees of performance. The third agency cost has to do with the residual welfare loss occasioned by agents’ decisions that do not maximize the interest of the owners.\textsuperscript{160} If these are the agency cost associated with organizations managed by fiat the potential agency costs are significantly higher in complex systems of multiparty transactions such as BOTs organized purely on the basis of contractual relations. Each party and each transaction within the project brings its own category of risks that must be identified, assigned and monitored. The agency cost associated with these cannot be underestimated.

The relationship between the bankers and the project company is purely one of creditor/debtor which nevertheless has agency cost implications. Creditors have to incur monitoring costs to ensure that repayment commitments are valid and honored. Guarantees, commitments, and undertakings by the host government to sponsors, lenders and other equity investors face similar agency costs. An appreciation of the nature and sources of these agency costs by policy makers should results in appropriate policy measures and incentives targeted at addressing them and facilitating the functioning and eventual transfer of the project to local interests.

BOT transactions also share many characteristics with other long term complex contractual relations such as joint ventures, licensing agreements and strategic alliances.\textsuperscript{161} All of these transactions are notoriously burdened by incomplete contracts because of bounded rationality and opportunism. While bounded rationality addresses the computational incapacity of the human brain, opportunism deals with human motives and motivations behind transactions.\textsuperscript{162} Parties to a contract may seek to take advantage of others through non disclosure


\textsuperscript{159}JENSEN, supra note 156, at 53-55.

\textsuperscript{160}Id. at 54.

\textsuperscript{161}Kathryn Rudie Harrigan, \textit{Joint Ventures and Global Strategies}, COLUMBIA J. WORLD BUS., Spring 1984, at 7 (offering a dynamic explanation of corporate joint ventures); Gullander, supra note 76 (describing joint venture strategies for complex transactions).

\textsuperscript{162}For strategic alliances a few examples of the vast literature will suffice; ALAN S. GUTTERMAN, THE LAW OF DOMESTIC AND INTERNATIONAL STRATEGIC ALLIANCES, (1995) (discussing a wide range of complex strategic alliance agreements); YADONG LUO, ENTRY AND COOPERATIVE STRATEGIES IN INTERNATIONAL BUSINESS EXPANSION, (1999) (providing the theoretical and strategic basis for international cooperative arrangements ranging from joint ventures to strategic alliances); Rosabeth Moss Kanter, \textit{Collaborative Advantage: The Art of Alliances}, HARVARD BUS. REV. (July-August 1994) at 571(explaining business strategic alliances as living systems, constantly evolving and requiring careful partner management techniques); Ranjay Gulati, \textit{Alliances and Networks}, 19 STRATEGIC MANAGEMENT J. 293 (1998) (discussing alliances as social networks with dynamic structures functioning styles and evolving governance structures).
of relevant facts, half-truths, even outright falsehoods or by skirting obligations ex post fact. The complexity and the multiparty nature of BOT transactions expose them to the same level of obligational and contingent incompleteness as other long term contracts.\footnote{Ian Ayres & Robert Gertner, \textit{Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules}, 101 \textit{Yale L.J.} 729 (contingently and obligationally incomplete contracts); Richard Craswell, \textit{Contract Law, Default Rules, and the Philosophy of Promising}, 88 \textit{Mich. L. Rev.} 489 (1989); \textit{Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules}, 99 \textit{Yale L. J.} 87 (1989).} Perhaps even more important in the BOT context is the risk of post contractual opportunism. Under the BOT model advocated here, each transaction would involve the making of irreversible specific asset investments in the form of plant, equipment and technology which cannot easily be redeployed. Oliver Williamson has explored the vulnerabilities associated with such investments.\footnote{Williamson, \textit{Economic Institutions}, supra note 58, at 52 (explaining the nature and vulnerabilities associated with specific asset investments).} Once a refinery or manufacturing facility is built it cannot easily be relocated or converted to other uses. And, the salvage value of the assets could hardly satisfy the cost of building them. Other BOT projects such as toll roads or tunnels suffer from similar vulnerabilities.

Given that the financing of BOTs is non-recourse or more likely limited recourse, the lenders, sponsors and all other equity investors are exposed to ex post contractual opportunism by the host government. In unstable regimes of post conflict states such as the DRC, Liberia or Angola, subsequent changes in policy or laws may compromise the cash flow of the project, the availability of hard currency to service debt or import necessary inputs. Such measures would undermine the financial viability of the project and its ultimate developmental objectives. In response to these risks, the host government may be required to provide contract stabilization measures and other guarantees that changes in policy and law would not alter the commitments, obligations and repayment terms of the BOT project. In appropriate cases sinking funds against revenue shortfalls may be recommended. Contract stabilization provisions in natural resource extraction and similar development agreements are not always desirable. There might be a greater justification for them in BOTs that fit into the industrial policy architecture recommended in this study.

The cursory examination of the contracting environment of BOTs suggests that a country that embarks on the BOT approach must address simultaneously all the fundamental policy issues relevant for an effective regime for the enforcement of contracts. An essential element of an effective BOT system is stability in expectations which can be provided through a BOT legislation that provides a clear and stable regulatory framework for BOT transactions.\footnote{See \textit{An Act Authorizing the Financing, Construction, Operation and Maintenance of Infrastructure Projects by the Private Sector and for other Purposes}, Rep. Act No. 7718, (1994) (Phil.), \textit{available at} http://www.chanrobles.com/default7.htm. For a discussion of this law see Navarro, supra note 127.} Such legislation would lay out the process, the criteria for participation, the process for project initiation, the bidding procedures and the general rights and obligations of the parties. Equally important for providing stability of expectations is the issue of dispute resolution. The complexity of economic development agreements and
their inherent political ramifications make them better suited to alternative dispute resolution than litigation in any courts. It would therefore be necessary for the BOT legislation to provide for the resolution of BOT disputes by conciliation, mediation or arbitration under any of the international arbitration procedures. It must however, be stressed that while a country may opt to be a signatory to the various international conventions for the settlement of investment disputes such as ICSID the need for settling such disputes by arbitration does not necessarily mandate subscribing to such treaties. Mandating arbitration in the BOT legislation should be sufficient as long as the parties are given freedom to make the choice of the arbitration institution or procedure. However, an effective arbitration mandate may require subscription to the New York Convention on the Enforcement of Foreign Arbitral Awards. For post conflict transition countries this gives additional confidence to lenders and other investors contemplating participating in BOT projects. It would appear that among the post conflict transition countries Liberia, Bosnia, and Mozambique but not the Angola, the DRC, and Rwanda are signatories to this Convention.

IX. MANAGING BOT PROJECT RISKS

Critical to the success of any BOT project is the identification, evaluation and allocation of the project risks. Each project type carries with it certain characteristic risks that must be addressed. Infrastructural and industrial projects are not only dissimilar in their characteristics but also in their associated risks factors. The allocation of the different categories of BOT risks has been the subject of some intellectual investigation which the interested reader can consult elsewhere. Consistent with the mission of this study, an in depth analysis of how these risks are identified, assessed and distributed is beyond the scope of this work. Our interest is limited to investigating how BOT risks might be addressed within the context of the framework of industrial policy to facilitate the management of such risks. Recall that the industrial strategic policy architecture is aimed at local processing of raw materials, value-added industrial upgrading, manufactured exports, technology transfer and creating linkages with the local economy. In this regard, one may ask what project risks might undermine these

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168 Tiong, supra note 151.

169 See infra Part IX.2
objectives and how might they be managed for the success of the industrial policy.

As a general matter, BOT risks might be described or identified by the type of project, the phases of the project or by the type of risk. To some, each project has a pre-implementation, implementation, construction, operating and transfer risks.\(^{170}\) To others, the risks might be viewed as startup, operating, technology, markets and political risks.\(^{171}\)

Irrespective of the classification of these risks, the basic principle in risk allocation is that risk should be distributed based on its source and the party that can best manage it.\(^{172}\) So, the question of great relevance is, what risks are traceable to the host government and which risks can it more easily and effectively manage?

Since the focus of this study is primarily on BOT projects for transforming post conflict transition countries the discussion that follows will address only those risks factors that the host government must manage to ensure success of its BOT policy objectives. In focusing on this limited set of risk factors we are nevertheless aware of the variety of other risk elements in BOTs that has generally been the subject of discussion. The following risks will be examined briefly below: (1) risk of government disinterest, (2) political risks, (3) foreign currency and input risks, (4) infrastructural risks, (5) force majeure risks and (6) transfer risks.

1. **Risk of Government Disinterest**

Once an industrial project has gone through its feasibility and approval phases and lending and investment commitments have been secured, the host government may simply move on to the next project. However, construction may be stalled for various reasons including shortages, cost overruns and other events. Or the entire project may collapse at that stage. For lenders, equity investors and others with different types of financial exposures such an event would be financially disastrous. The cash flow from the project is essential for the loan repayment and some reasonable returns on investment are contingent on a completed and operational project. None of this would come to pass if the project fails at its construction phase. It is therefore generally argued that the success of project finance projects depends on some level of host government involvement.

There are different ways in which the host government’s interest in the success of the project can be sustained beyond approving it and hoping for its success. This can be achieved by government participation in the project company as an equity investor. As indicated in Diagram 2 above the government participates in the project company as an equity joint venture partner with the sponsors directly or as one of the sponsors under the shareholder agreement. With an equity investment in the project the government is unlikely to walk off and remain aloof from the fate and fortunes of the projects. In the alternative or

\(^{170}\) Tiong, *supra* note 151.

\(^{171}\) Farrell, *Principal-Agency Risk, supra* note 153, at ___.

\(^{172}\) Tiong, *supra* note 151
even in combination with its equity participation the government may offer certain guarantees and commitments to make funds available should some unforeseen events threaten the completion of the construction phase of the project.

(a) Dedicated Post Conflict Finance Fund

One of the constraints post conflict transition countries face is financial resources and inadequate access to international money markets where they can raise capital for these projects at a reasonable cost. So, one may legitimately ask how the host government can make these financial contributions. The answer may lie in having access to a “Dedicated Project Finance Fund” earmarked for the transformation of post conflict transition countries. Every year the G8 makes promises of increasing foreign development assistance aid to poor countries. Many other developed countries offer various forms of development assistance to developing countries. In his book, The End of Poverty, Jeffery Sachs has advanced as passionate a case for development assistance aid as one could possible make.\(^{173}\) He argues that with foreign aid that raises the per capita stock from $900 to $1,800 over several years will help countries break through the poverty trap.\(^{174}\) However, several studies have argued that decades of foreign development aid programs have failed as instruments of economic development.\(^{175}\) One must then question not the passion or the compassion but the wisdom of a policy prescription most people believe is faulty and ineffective. Sachs’ mission in The End of Poverty is to end poverty through mostly donor aid which is vastly different from empowering private entrepreneurial risk taking in targeted industries with the greatest potential for development impact. The one has minimalist elements and the other is rather boldly self-reliant. Thus, in the case of post conflict transition countries, a much more fruitful approach might be to redirect some of the development assistance funds to a special fund to support the economic transformation of these countries through project finance and other private enterprise driven programs.

\(^{173}\) JEFFREY D. SACHS, THE END OF POVERTY (2005) (provides a passionate analysis of root causes of poverty and offers several solutions, some times referred to as the “Big Push” but perhaps better seen as minimalist on how it might be ended).

\(^{174}\) Id. at 250 (assigning a dominant role to donor aid; without donor funding he argues the necessary investment simply cannot be financed and poor people will remain in a poverty trap).

\(^{175}\) EASTERLY, supra note 53, at 38-40, 50 (arguing that Aid even within the right policy environment does not work; the evidence shows that the poorest countries can grow without Aid). Aart Kraay & Claudio E. Raddatz, Poverty Traps, Aid and Growth, (World Bank Dev. Res. Group, Working Paper No. 3631, 2005); William Easterly, Ross Levine & David Roodman, Aid, Policies, & Growth: Comment, 94 AM. ECON. REV. 774 (2004) (finding that Aid does not improve growth in poor countries with sound policies); Raghuram G. Rajan & Arvind Subramanian, Aid and Growth: What Does the Cross-Country Evidence Really Show?, 90 REV. ECON. & STATS. 643 (2008) (showing that after adjusting for possible bias, Aid does not have an effect, positive or negative, on growth in developing countries with sound economic policies).
One of the benefits of such a fund is that access to it can be designed not to be hand outs to governments but rather aimed at projects that have been approved under the rigorous project finance requirements. In this sense the funds would not go to the government but to projects that are capable achieving the development objectives through private investment activities. So much criticism is often leveled at the corruption that comes with foreign development aid. We wonder whether this direct approach to supporting private risks taking in development driven projects would not only reduce corruption but actually lead to successful development driven projects. However, the government may borrow from it for its equity contribution to project company. The government may also borrow from it for its guarantee for cost overruns or shortfalls in revenue and similar risks. In this sense the funds do not go directly to the government nor is there a free lunch. The Fund may also be accessed by local sponsors involved in the project to whom the project will ultimately be transferred after it has paid for itself. As such the Fund, once established, would have the capacity to replenish itself over time from successful projects through the repayment of loans taken from it either by the government or local sponsors. Finally, because each project will be substantially financed by non-recourse or limited recourse debt access to this fund is less likely to be abused particularly if certain restrictive criteria are imposed to address the potential for abuse.

2. Political Risks

One of the most significant risks in BOT projects in developing countries is political risk. Political risks cover a wide spectrum of politically motivated events and government policies ranging from labor unrests, government fiscal and economic policies to outright expropriation and nationalization. These events may undermine the construction or operational efficiency of BOT projects. In the context of post conflict transition countries, the ever present

176 Tiong, supra note 151, at 325; Farrell, Principal-Agency Risk, supra note 153, at 550; Hoffman, supra note 116, at 40 (devoting several pages to a discussion of various types of politically motivated risks that might rise in project finance); Wendy B. Woody & Heydar Pourian, Risk Assessment and Options in Project Finance, 23 PROJECT MGMT. J. 21, 25 (1992) (pointing out the range of political risks including outright hostility to the project); Dannielle Mazzini, Stable International Contracts in Emerging Markets: An Endangered Species?, 15 B.U. INT’L L. J. 343 (1997) (discussing the problems encountered by the notorious Enron Corporation in the State of Maharashtra in India with respect to its power plant and the unilateral termination of the contract by the government); see generally, Frank C Shaw, Reconciling Two Legal Cultures in Privatization and Large Scale Capital Projects in Latin America, 30 LAW & POL’Y INT’L BUS 147 (1999); S. Baker, D. Fonniah & S. Smith, Techniques for the Analysis of Risks in Major Projects, 49 OPERATIONAL RES. SOCIETY 567 (1998) (providing a general methodology for assessing risks which could then be managed); James E. Smith & John F. Nau, Valuing Risky Projects: Option Pricing and Decision Analysis, 41 MGMT. SCI. 795 (1995) (discussing and comparing at the theory level options in pricing risky projects); Carl R. Beldleman, David Veshosky & Donna Fletcher, Using Project Finance to Help Manage Project Risks 22 PROJECT MGMT. J. 33 (1991) (providing a general description of various types of risks that can be managed through project finance).
security risks tend to magnify their actual or perceived political risks. In most circumstances, the sources of BOT political risks tend to be the host government. In any event, because of the nature of these risks, the host government is generally better positioned to manage them. The focus of any political risks management strategy should be shifting the cost of these risks to the host government by employing techniques similar to those used in the basic turnkey or production sharing/service contract models.

With the project funded substantially by debt and some equity, the private parties face specific asset investment vulnerabilities should they hold direct or collateralized property rights in the assets of the project company. For, any government measures that compromise the cash flow or the viability of the project would visit significant losses on the private parties. Since the goal is to transfer the project to local interests the materialization of political risks could precipitate that transfer in a fire sale to the detriment of lenders and equity investors and other creditor stakeholders. And, it would be no consolation to them that such measures may destroy the credit worthiness of the country and its investment climate.

However, a combination of *ex ante* political risks management techniques could be used to shift substantially the specific asset vulnerabilities to the host government. Under the production sharing/service contract model, the government and the future private interest holders have the ownership interest in the project, as in the case of the basic turnkey agreement. The sponsors, as service providers, may operate the project under a lease or concession granted by the government for a period of time sufficient to service the debt and give investors a reasonable return on their capital. Such arrangements may include various forms of subsidiary contracts such as technical assistance agreements to ensure that the technology of the project is upgraded as often as needed. The key point here is that the *government cannot expropriate what it owns*. It may however interfere with the lease or the activities of the project company and additional measures may be required. An agreement to indemnify the lessee and all creditors for the full amount of the outstanding debt and equity taking into account a reasonable return on equity laced with a cross default clause could serve as a significant deterrent to breach. To ensure that guarantees of

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177 For turnkey contracts see UNCTC, FEATURES AND ISSUES IN TURNKEY CONTRACTS IN DEVELOPING COUNTRIES, A TECHNICAL PAPER, (1981); for Production sharing and service contracts, see Ernest E. Smith, *From Concessions to Service Contracts*, 27 TULSA L. J. 493 (1992) (discussing the evolution of mineral contracts towards the production sharing and service contracts to give governments greater say and take in the proceeds); SMITH & WELLS, THIRD WORLD MINERAL AGREEMENTS, supra note 176; UNCTC, TRENDS IN PETROLEUM AND MINING AGREEMENTS, supra note 76; Machmud, supra note 149.

178 Cross default clauses are a staple in syndicated loan agreements because they are generally worded broadly enough to work as a deterrent to breach. The typical cross default clause is broadly worded to cover defaults on any indebtedness in the event of which the indebtedness is accelerated or capable of being accelerated. Indebtedness covers all financial obligations to other creditors. See, PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 256 (1980) (chapter 11 devoted to the loan syndication and its implications); Keith Clark & Andrew Taylor, *Events of Default in Eurocurrency Loan Agreements*, 1 INT’L FIN L. REV. 12, 13 (1982).
indemnity are not empty promises, the government may be required to carry political risk insurance covering the value of project as security. But the creditors and equity investors may also carry political risk insurance with any of the many political risk insurance programs such as OPIC and MIGA. Ultimately, the insurers will have the right to recover any payout from the host governments thereby again shifting the risk of loss to the host government. Finally, to encourage lenders and equity investors to participate in the economic development objectives of developing countries, the private parties should be allowed to recover all political risks induced losses form the Dedicated Project Finance Fund at the cost of the host government. In other words, the Fund would charge the payout amount to the host government as debt to be paid to the Fund.

These political risks shifting techniques may appear harsh but we should not lose sight of the goals and objectives of the host governments. The basic strategy of relying substantially on non-recourse or limited recourse lenders and some equity investors to create industrial enterprises with developmental impact imposes significant risks on the lenders and investors. It is not asking too much to insist that political risks management techniques be employed to eliminate post contractual opportunism by the government. Nor should the government expect a handout from the private parties willing to take some risk to advance its development goals.

3. Foreign Currency and Inputs Risks

One of the most significant risks in project finance transaction of any type is foreign currency risk.\(^{179}\) In addition to the complexity of the contractual relations among the multiplicity of parties and funding sources are the currency requirements for debt service. While the project funding and debt service obligations might be in hard currency the revenue generation might be in local currency that must be converted into the appropriate currency to meet those obligations.\(^{180}\) Moreover, the BOT project may require foreign currency for the importation of equipments, raw materials or other inputs for effective operational success. In this regard, BOT projects face several foreign exchange risks including inflation, the unavailability of foreign currency, restrictions on transfers, exchange controls and currency devaluation risks. The currency risks could extend to the restrictive allocation of hard currency necessary for the importation of materials and inputs for the BOT manufacturing facility. There are various currency risks management techniques advocated in the project finance context. Some of the measures include political risk insurance with OPIC and MIGA or even commercial currency swaps by lenders and other project participants.\(^{181}\) However, our focus is on those measures that should be undertaken by the host government proactively to mitigate the currency risk to ensure a greater potential for successful projects.

\(^{179}\) HOFFMAN, supra note 116, at 40 (discussing a wide range of currency risks associated with project finance).

\(^{180}\) Id.; Tiong, supra note 151, at 323.

\(^{181}\) HOFFMAN, supra note 116, at 44-45.
Government measures aimed at mitigating currency risks should be part of the basic BOT policy framework. We have argued above that as part of its industrial strategic policy architecture the government should enact a BOT legislation that provides the framework for all BOT transactions. Mitigating or even eliminating currency risks should be one of the goals of a BOT legislation. The BOT legislation must guarantee currency convertibility under a single exchange rate if multiple exchange rates exist. In addition, BOT projects should be given equal access to the allocation of foreign currency as other enterprises and institutions. In short the host government must liberalize its exchange controls regime in the project finance and BOT framework even if there are legitimate economic reasons for general exchange controls.

A special exchange control liberalization program within the BOT legislative structure would serve several purposes. It would permit the BOT process to bypass some of the bureaucratic approval bottlenecks in an area critical to BOT funding. It would provide a statutory process that streamlines and eliminates bureaucratic or administrative consensus based decisions or discretion often the source of corruption. The experience in some Asian countries suggests that the administrators charged with implementing these laws must be given clearly defined responsibilities to prevent bureaucratic graft. It will be difficult if not impossible to get lender participation if there is little confidence that the necessary foreign currency would be available for debt service. As such, the BOT legislation might include the approval of off-shore accounts and the use of local foreign currency accounts. Indeed, an off-shore account might be a condition for foreign lender participation in BOT projects. A legislation that permits such accounts will impose a legal obligation on the Central Bank to authorize the accounts and the amounts of money that can be held in them. In the case of industrial projects with manufactured export products, purchasers could then make payments directly to these off-shore accounts from which various disbursements can be made. The authorization of local foreign currency accounts will also give BOT projects direct access to foreign currency to address their foreign currency needs and bypass the bureaucratic issues associated with exchange controls and Central Bank allocation of foreign currency to BOT projects.

4. Infrastructural Risks

The central tenet of the industrial strategic policy architecture for transforming post conflict transition countries is an emphasis on industrial

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182 LANG, PROJECT FINANCE IN ASIA, supra note 122, at 41-43 (explaining the absence of legislation in some Asian countries and the politicization of government commitments as a source of corruption and politicians jockeying for power as a significant hurdle to project finance.)

183 Id at 43-46 (explaining that in China the Administrators did treat contracts as binding and although India has a developed legal system the system of corruption was decentralized).

184 HOFFMAN, supra note 116 at 45; Tiong, supra note 151, at 323.
upgrading based on local processing of raw materials, local value added and manufactured exports. An essential element of this policy architecture is the existence of basic infrastructure such as power plants, roads and other public facilities that can support manufacturing activities. One of the reasons for the miraculous economic performance of the Asian Tigers is the development of basic infrastructure either through direct public expenditures or through project finance. Unfortunately, one of the major constraints of post conflict transition countries is the absence of such basic infrastructure. Conflict often leaves countries with devastated infrastructure, weak, low grade unreliable power plants, terrible roads and inadequate ports and airport. So, any industrial policy aimed at transforming these countries through manufacturing facilities must confront the infrastructural problems at hand.

The host government must then confront the inadequate infrastructural needs within the industrial strategic policy architecture. Put differently, not only must the host government implement an industrial upgrading policy but must simultaneously upgrade its infrastructure as a necessary element of that policy. Infrastructural development can be undertaken through direct government expenditures but in view of the financial constraints of post conflict transition countries project finance is the likely candidate for fulfilling that need. An examination of the power plants project finance practices in Asia suggests various models that can be used by the host country to achieve its objectives. Indeed, one might argue that the prerequisite for the industrial strategic policy architecture of any country is the existence of basic infrastructure. Developing such basic infrastructure would stabilize the infrastructural needs of the country to meet current demand and the building of a series of BOT industrial projects would create additional demand for the power generation projects. The sequence of investment activities in this regard would be critical. With the power plants in operation, the government can guarantee the power supply to the projects through various arrangements and techniques common to power plant and other infrastructural projects.

5. Transfer Risks

The basic premise of the BOT model is the eventual transfer of projects to local interests. Such a transfer may take place after the project has paid for itself and the equity investors have receive a reasonable return on their investment. The transfer may also take place after an agreed upon time has expired. Whatever triggers the eventual transfer, that final phase of BOTs is not free from risks. Assuming that the project achieves its objectives and expected cash flow levels

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185 LANG, PROJECT FINANCE IN ASIA, supra note 122 (devoting several chapters to power plants and some of the special cases of project finance in Asia); Handley, supra note 145, at 209-211.

186 LANG, PROJECT FINANCE IN ASIA supra note 122, at 93 (providing an interesting discussion of the background and path to success of Hopewell Holdings in the project finance arena; a hotel project gave rise to the vision of major infrastructural project finance projects).
and lenders and equity investors are fully paid as expected, the local joint venture
sponsor partners must now take over the operations. However, their initial
investment in the project will not be sufficient to cover the current market value
of the project. They must come up with additional financing to purchase the
entire facility or invite other local investors to participate in the venture. The
likelihood that they or the other local investors would have access to capital at a
reasonable cost may be low. The host government may then address this capital
scarcity by offering loan guarantees to the local investors to seek private funding
either domestically or in the international money markets.

If on the other hand the transfer is triggered by the expiration of a fixed
contractual term but the lenders and equity investors have not yet been fully paid
a new set of risks face the private party stakeholders. There will be no guarantee
the facility under new local management will be able to generate the necessary
revenue to pay the outstanding debt and equity interest. It may well be argued
that such a risk of loss is what the lenders bargained for. However, because BOT
contracts are notoriously incomplete, certain adjustments should be made to
address the equities in the relationship. A well constructed BOT contract would
have made provision for adjustments particularly in the case of a fixed term
contract. In view of this, the host government might be required to settle the
outstanding obligations and take equity interest in the project, or provide a loan
or loan guarantees to the local sponsors and other interested parties to buyout the
foreign private interest. In the alternative, the Dedicated Project Finance Fund
could provide a standby loan guarantee for the private parties to acquire the
project.

Other transfer risks might materialize when a fixed contract term expires.
The products of the project may lose their competitiveness in the marketplace
because of declining demand, changing consumer taste or due to other business
conditions. The technology of the project might also be overtaken by new
innovations thereby increasing cost and dampening price competitiveness. These
markets and technology risks might materialize even when the feasibility
studies were well conducted and proven technology was chosen. Under these
circumstances, all the parties and stakeholders face some risks. The lenders and
investors may have to absorb some losses; the new local owners would inherit an
underperforming enterprise and there would be little incentive for them to pay off
the outstanding debt. Besides, the policy objectives of the host government may
not be achieved.

The response to market and technology risks would require some additional
capital outlay by the new local owners. In the case of projects with flexible
factories, changes in demand and consumer tastes and preferences may not affect
productivity. The projects may lose some manufacture-to-order clients but gain
others. However, changes in technology can be addressed by retooling and
upgrading through government guaranteed loans. The response to market and
technology risks for industrial projects is less straightforward. Changes in
consumer tastes may require a total new product design or may lead to a collapse
of the project. The cost of responding to market and technology changes could be
substantial and again the new local owners would need substantial financial

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support in the form of government guaranteed or subsidized loans to respond to these changes if the projects can continue to serve the development objectives of the host country.

X. SHIFTING THE FOCUS OF INCENTIVES IN BOT POLICIES

In his famous book on The Economics of Welfare published in 1920, Pigou advanced the broad conceptual basis for incentives granted to enterprises to correct for the greater social returns on private investment than the private returns received by the investors. According to Pigou, private investment might result in positive externalities such as economies of scale, increase in new knowledge, and new herd mentality induced investment generated by the initial investment. Whatever the private returns on investment might be they will not reflect these positive externalities because the market is incapable of rewarding such contributions. Incentives are therefore necessary to correct for these unrewarded contributions. In more recent times, others have advanced what might be termed a dynamic growth development thesis for incentives. They argue that incentives might be appropriate within the context of growth and development dynamics in developing countries. In their formative stages, industries in developing countries may face higher cost, other challenges and constraints characteristic of countries forging their industrial paths through infant industries. Incentives might play an essential role of supporting these industries at their formative stages. Such was the experience of Japan and many other Asian economies that followed its extraordinary transformation. And the question is whether these two broad conceptual frameworks can support the case for incentives for FDI in post conflict transition countries and if so in what form.

In response to the question posed about the relevance of incentives, it should be noted briefly that neither Pigou’s theory of incentives nor the dynamic development version of it endorses a blanket use of incentives. Both theories are *purposive*. Under Pigou’s theory, incentives are not necessarily inducements for investments that would otherwise not have been made. Rather incentives are corrections for under rewarded investment for their positive externalities. The theory does not necessarily assume that the investment would not be made. If this interpretation is sound investments with known or a high likelihood of negative externalities should not be candidates for incentives under this theory. Similarly, the dynamic development theory of incentives would not necessarily support incentives if the development prospects of an infant industry are not probable or feasible under the circumstances.

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188 ARTHUR C. PIGOU, THE ECONOMICS OF WELFARE (1920).
189 UNCTAD, INCENTIVES AND FOREIGN DIRECT INVESTMENT, TD/B/ITNC/Misc. GE.95 6 APRIL (1995) at 5.
190 Id.
1. A Brief Historical Review of Incentives

Notwithstanding the general conceptual framework advanced by Pigou and the dynamic growth and development theory of incentives, the theory of incentives for FDI is less settled than the practice by host countries. For decades, numerous theoretical and empirical studies have challenged the theoretical basis for incentives, questioned the efficacy of incentives for FDI and doubted the causal link between incentives and the actual investment behavior of investors. Indeed, in an earlier study, we provided a comprehensive review of contemporary legal, survey and economic studies on the efficacy of tax incentives in the FDI process. The survey studies covered a geographic area, stretching from North America to Europe in developed countries and from Latin America to Africa and Asia in developing countries. Similarly, these studies covered a long time frame, running from the 1920s to the 1980s. Consistent in all of these studies were findings that tax incentives had little if any impact on FDI location decision process. More recent survey studies and more rigorous econometric time series analysis of the same question have yielded substantially the same results: tax incentives do not have an impact on the location decisions of FDI. The results of survey studies are hardly surprising. For, survey studies always run the risk of manipulation by respondents motivated by objectives other than rational investment decision choices. For instance, in a study of the tax holidays experience of Indonesia Louis T. Wells and Nancy J. Allen reported that although the Japanese firms complained bitterly about the repeal of the tax

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191 Id. at 30.
193 Yelpaala, Efficacy of Tax Incentives, supra note 10, at 396.
194 Id. at 396-413.
196 Yelpaala, Efficacy of Tax Incentives, supra note 10, at 403 (arguing that surveys allow business executives to reveal their subjective preferences which may have nothing to do with their objective decision processes).
holidays in Indonesia, Japanese investments continued to grow rapidly.\(^{197}\) This clearly confirms the argument that tax incentives are often redundant in that the investment would be made without them which was the case with the Japanese investments in Indonesia.\(^{198}\)

Although the theory and empirical evidence seem to point in one direction host countries competing for scarce FDI resources seem to be looking in the opposite direction. Since the decades of the 1990s there has been a remarkable and almost irreversible competition for FDI through generous incentives. According to Andrew Charlton, the competition is so pervasive that countries, states within federal systems and regional trade organizations and even regions within countries find themselves pitched against one another with generous incentives for wooing FDI.\(^{199}\) An UNCTAD study in 1994 of 103 countries found that only 4 of them did not offer any incentives for investments.\(^{200}\) The intense competition for FDI has also led to a global legislative movement towards the liberalization of the foreign investment climate and regulatory regime in many countries. According to UNCTAD World Investment Report of 2000, of about 1035 changes in the regulatory environment worldwide, about 94% made the legal environment more favorable.\(^{201}\) Globally, there is growing convergence and harmonization of the regulatory environment towards greater favorable treatment of investors. It is important to note that most measures undertaken by countries were liberalization measures made from the point of view of the dynamic growth and development thesis. And this is the context in which we shall approach the case for incentives in post conflict transition countries.

The history of disappointing performance of incentive in attracting FDI compels caution in crafting any policy prescriptions for post conflict transition countries. The case for caution is further bolstered by the fact that decades of liberalization of investment regimes worldwide has yet to bear fruits in FDI inflows. The proliferation of bilateral investment treaties in developing countries as instruments for investment protection and promotion seems to make little difference in attracting FDI to developing countries.\(^{202}\) However, incentives


\(^{200}\) UNCTAD, *INCENTIVES AND FDI, supra* note…at 10.

\(^{201}\) UNCTAD, *WORLD INVESTMENT REPORT 2000, supra* note 25, at 1. According to this UNCTAD report, the efforts to attract investment included the conclusion of bilateral investment treaties which increased tremendously between 1980 and 1999. In 1980 there were about 181 bilateral investment treaties concluded. By 1999, the number had increased more than tenfold to 1,856. Double taxation treaties increase from 719 in 1980 to 1,982 by the end of 1999. *Id.*

\(^{202}\) UNCTAD, *WORLD INVESTMENT REPORT 2003, supra* note 26, at 36. According to this report as of 2003, the conclusion of at least 533 BITs in Africa translated into an average of 10 BITs per country. In addition, African countries had, by the end of 2002, concluded
impose a direct and indirect cost to host countries without the necessary corresponding benefits. Incentives are not only a burden on the treasuries of the host countries but also work as reverse subsidies of affluent countries and their investors by poor developing countries.\textsuperscript{203} For this to continue there must be some rational justification. It therefore seems incumbent on any investment policy design that as one of its objectives the attraction of FDI through incentives to investigate why these incentives have not worked.

2. \textit{The Framework for Incentives in the BOT Model}

The policy architecture for transforming post conflict transition countries advocated in this study does not rely on conventional FDI as a primary instrument. Its focus on the combination of substantial debt and some equity in economic development suggests that conventional incentive policy levers would be unsuitable for the task at hand. That notwithstanding, any design of an incentives policy framework must start with the reasons why incentives have failed to be effective and respond to them effectively.

As is apparent from the discussion above, several reasons have been suggested for the ineffectiveness of incentives. The first line of reasoning traces the problem to the theoretical basis upon which incentive policies are designed. Incentives do not address the real determinants of FDI such as market size, the possession of exploitable intangibles assets, or the imperatives of circumventing costly open market transactions burdened by uncertainties and chronic market failures that require internalization.\textsuperscript{204} Distilled from these theory-based arguments is a simple but powerful suggestion that incentives and their policy constructs are often misguided and this is an observation that policy makers cannot ignore. Incentives are misguided when they are not aimed at known or proven impediments to, or the real motivations for, FDI. Rather, most incentives tend to be general in the sense that they are made available to all qualifying investors who are not always required, if ever, to make some positive contribution to some developmental objectives or address some specific national problem. Even when incentives are targeted at specific industries, investment activities, technological contribution or labor absorption investments, they still retain their basic general characteristics.

Incentives also face other problems. Most incentive regimes disaggregate the responsibilities of granting incentives from those of assessing their costs. Investment promotion agencies, charged with the single task of increasing investment flows, are eager to grant incentives to achieve that goal. However,

\begin{itemize}
  \item \textsuperscript{203} Yelpaala, \textit{Efficacy of Tax Incentives}, supra note 10, at 388, 392; Wells & Allen, \textit{supra} note 195, at viii.
  \item \textsuperscript{204} Yelpaala, \textit{Alternatives to Tax Incentive}, supra note 56; \textit{BUCKLEY \& CASSON, supra} note 56.
\end{itemize}
investment promotion goals may be pursued without regards to the cost of incentives to society and the treasury. Moreover, incentive schemes tend to give discretionary powers to administrators. The consensus seems to be that discretion based incentives tend to fail because they are prone to induce corruption, increased-costs and other abuses that discourage serious investors from pursuing the incentives.205

The misguided nature of general incentives should be eliminated within the context of the Industrial strategic policy architecture advocated in this study. To the extent that projects are chosen based on their potential contribution to some developmental goals of the host country there are greater opportunities to make incentives work. As a start, any incentives regime cannot be general but specific to types of projects. Because projects differ by type and level of complexity, the incentives can be tailored to the needs of each project type or each specific project. Generality and redundancy in incentives can be eliminated by subjecting incentives to the cost and benefits analysis within the capital budgeting process of each project. For instance, incentives may be given for training a specific number and caliber of technical and management personnel per year for the project. Incentives can also be given based on the value of manufactured exports per annum generated by the project. Both of these are performance based and their cost and benefits can be estimated within the capital budgeting process.

The central theme of any incentive regime is to encourage investment that would otherwise not take place. The goal of the incentive regime within the project finance and BOT context should be to channel potential sponsors and other equity investors towards specific projects for the achievement of certain development objectives. Thus, the basis for any specific incentives should be some quid pro quo between the incentive recipients and the host government. Each incentive or incentive type can more easily be assessed in terms of their cost and benefits if some bargain for exchange formula is used. Achieving such quid pro quo may not be easy but the search for it would compel a higher level of transparency and deliberateness in the grant of incentives.

One of the drawbacks of general incentives is that they tend not to take into account the fact that all development incentives are not perfect substitutes for one another. Different incentives have different levels of value to the investor and cost to the host government.206 Low value incentives in whatever form they come are unlikely to be effective although they visit a cost on the treasury of host government. However, with the project chosen the specific investors will be known and their incentive preferences or which incentives would work best in the specific context can be identified. A requirement for some quid pro quo would compel tighter scrutiny of incentives and increase their likelihood of efficacy.

205 Wells & Allen, supra note 195, at 36 (arguing that highly a discretionary approach to incentives may be doomed to failure).

206 David W. Rasmussen, Marc Bendick, Jr. & Larry C. Ledebur, A Methodology for Selecting Economic Development Incentives, 15 J. PUB. URBAN & REGIONAL POLY 18, 24 (1984) (arguing that different incentives have different values to investors and impose different costs on the granting public institution).
The BOT model can also address effectively problems associated with highly discretionary incentive regimes. We have already argued that a BOT legislation is essential to provide a clear and concrete regulatory framework for project participants. One of the goals of such legislation is to reduce the exercise of discretionary power which is often the source of corruption. The general framework for incentives should be designed within the BOT legislation with the goal of reducing discretionary incentives. Categories of incentives might be earmarked for different project types as long as their use is contingent on the cost and benefits analysis within the capital budgeting process of each project. The use of incentives and qualifying investors might involve limited discretion but ultimately the grant of incentives would still be subjected to the rigors of the capital budgeting process.

3. Summary

In summary, the goal of this brief historical survey and analysis of incentives for FDI is to suggest that there is a need to shift the focus of development incentives. After almost a century of investigation the evidence points to the conclusion that economic development incentives are hardly ever effective even as they visit costs on the host government. In the face of such evidence the case for the use of incentives by post conflict transition countries must be compelling or at least ensure their success. We have argued that to make incentives relevant to the development goals of post conflict transition countries certain conditions must be met. The use of incentives must be guided by a BOT legislative framework that diminishes significantly the role discretion in the granting of incentives. Within the context of the BOT model, incentives must be specific and deliberate as to projects targeted and their contribution to the goals of the host country. The efficacy of incentives in terms of the benefits and costs to all parties will be enhanced if each incentive is based on a quid pro quo arrangement and assessed within the rigors of the capital budgeting process of each project. This approach allows each country to tailor its incentives regime to the needs of its economy and industrial strategic policy architecture for effectiveness.

XI. CONCLUSION

Several post conflict transition countries where people are living on less than $2 a day, are some of the poorest countries in the world. Such abject poverty in a world where affluent nations wallow in transcendent abundance is unacceptable and demands a response as a moral or humanitarian imperative. In 2000, all the members of the United Nations adopted the Millennium Development Declaration and Goals (MDGs) aimed at, among many others, eradicating extreme poverty and hunger. The MDGs stands as a colossal beacon inviting the attention of any person charged with constructing a blueprint for the transformation of post conflict transition countries. Nevertheless, the achievement of the MDGs had remained largely elusive by 2005.
The MDGs does not, and cannot, claim monopoly over the concerns or the solutions for poverty eradication in the world. Clamoring for equal attention in any poverty eradication policy design and directed objectives are two other very popular instruments: (1) Official Development Aid (ODA) and (2) FDI. ODA programs are best exemplified by the Blair Commission Report of March 2005 presented at the G8 Conference in Scotland and calling for ending poverty in Africa as the primary focus of that Conference. Every year, the G8 focuses attention on addressing development needs through ODA. The G8 Conference of 2008 held in Hokkaido Japan continued to pursue ODA as an instrument for addressing poverty and development. Given the historic central role assigned to ODA in development, logic would dictate that ODA must be in play in any industrial strategic policy architecture with the goal of transforming post conflict transition countries. After all, most if not all, of them are the targets of ODA and poverty alleviation measures. Many have also assigned a significant role to FDI in the achievement of economic development goals.

In this paper, we reject these approaches as the starting point for crafting industrial policies for transforming post conflict transition countries. In doing so, we do not reject the necessity for poverty alleviation. The real question is, what is the most effective way of putting these countries on the path to sustained economic self transformation overtime such that poverty does not remain a burning and recurrent issue. After decades of ODA programs, the poor countries have remained poor and some have gotten even poorer relative to their own history and in relation to the rest of the world. Although the poverty alleviation policies may often be well intentioned, unimpeachably humanitarian, and passionately argued, at their core they are mostly minimalists both in intent and potential impact. Poverty alleviation instruments would have greater effects within a larger industrial framework that focuses on empowering the entire economy through projects and industries with the potential for the greatest development impact. Conventional FDI instruments may also be misplaced both in post conflict transition countries and in other developing countries. An understanding of the systems characteristics, strategic vision, and the mission of MNEs would suggest that we should not put the developmental burden of countries on MNEs when, as direct instruments, they are not well suited for that task. This also does not mean that FDI cannot play a role. It only means that the role FDI plays must be complementary and should not be left to the investors. It must be guided by the industrial strategic policy architecture of the host country.

In view of the arguments advanced above, we conclude that the industrial strategic policy architecture for transforming post conflict transition countries must focus on big prizes- that is, investing in and developing industries and projects with the greatest potential impact on economic development that empowers the local economy and entrepreneurs. A policy that keeps its focus on big prizes in the economy is not the same as the current emphasis in certain development circles on “big push”. The basic policy framework for countries with abundant natural and human resources should be to avoid exporting any commodities, products or ideas unprocessed. These countries must seek out investment opportunities with the greatest potential for value-added- technology and knowledge transfer and the generation of meaningful linkages with the local economies. Even countries with meager economic resources should reconsider
how they fit into the utilization of the vast global resources for their
development. The real reasons for poverty might only be the poverty of
imagination.

To achieve these goals, we propose the use of the project finance and BOT
models. Under these models, industrial projects that can pay for themselves will
be funded substantially through non-recourse or limited-recourse debt and some
equity. The projects will be turned over to local owners after they have paid for
themselves. In this process, the host government provides an effective guiding
hand in the selection of industries and projects that serve its development goals.
This approach is not free from risks but at least the host governments will take
charge of their economic destiny.

Also, under this approach, some of the ODA financial resources that have so
far proved to be ineffective can be put to a different use through a dedicated
Fund. Such a Fund will finance BOT projects and support private entrepreneurial
investment activities. The Fund could produce several benefits: (1) it would
provide direct support to carefully selected home-grown economic development
projects; (2) it could lend great support to the creation of self-reliant local private
industries and an entrepreneurial class which is essential for sustained economic
development and (3) it could break the circle of wasteful and corrupt ODA
expenditures with little to show for them.

Finally, no economic development model is without risks. Certainly, there is
no silver bullet. However, the need for altering the position of the poorest
countries in the global economy demands the use of bold and non-conventional
techniques that have worked in other regions of the world. Indeed, although this
model is designed for post conflict transition countries, the basic approach has
utility in many developing countries with or without abundant natural and human
resources. One only has to look at the examples of the Asian Miracles with
diverse cultures and historical experiences to appreciate this point. We maintain
that their incredible economic transformation was not just a simple function of
culture but also sound policy choices.