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Public Support for Private FDI as a Development Strategy: Getting the Politics Right

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Catalysing private foreign direct investment (FDI) has emerged as a priority for many bilateral and multilateral development agencies. While there is significant potential for FDI to help deliver progress on sustainable development in the coming decades, there are also important political questions about the distribution of gains and the possibility of diverging interests between multinational companies (MNCs) and developing countries.

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Development agencies sponsoring and encouraging such projects must not be caught unawares, and need to proactively develop strategies to manage these political questions before controversies arise. Specifically, when providing public support for private FDI into developing countries, every development agency should ask itself:

- What role will the agency play in commercial negotiations between MNCs and developing country governments, and how can it ensure developing countries negotiate deals that will help deliver sustainable long term development?
- What level of transparency will be expected in agreements involving private companies, and what are legitimate grounds for exceptions to transparency guidelines?
- Under what conditions should the agency apply political pressure to the host state government to resolve potential investment disputes, and what political remedies can be legitimately used to support commercial transactions?

There are no clear-cut right or wrong answers to these questions; there are trade-offs in any approach, and each development agency might weigh these trade-offs differently. What is important is that, amidst the understandable excitement around new policies for catalysing FDI, the inherent distributional conflicts and political challenges are not ignored or swept under the rug. Development agencies – and the advocates and journalists who hold them to account – need to strategically and deliberately assess how, through both action and inaction, they will influence conflicts between MNCs involved in these projects and the developing countries which are meant to be their ultimate beneficiaries.

FDI AND THE NEW LANDSCAPE FOR DEVELOPMENT FINANCE

At the United Nations' 3rd Financing for Development conference, held in Addis Ababa last July, the energy and optimism surrounding the role FDI could play in spurring growth and fighting poverty was evident. As Sir Suma Chakrabarti, the head of the European Bank for Reconstruction and Development, put it, "there is a paradigm shift going on," away from traditional official development assistance and towards mobilizing private investment. [1]

This shift has been driven by multiple factors. To begin with, the scale of the financing gap in developing countries is so great there is a clear need for new sources of funding; for example, incremental investment requirements in infrastructure in developing countries is estimated to be in the range of $1 trillion a year[2]. Foreign investment – alongside greater domestic revenue mobilization – is one of the most promising sources of funding to help close such gaps. Furthermore, given the strained budgets amongst most members of the OECD's Development Assistance Committee, there appears to be little scope for significant increases in official development assistance in the coming years. Finally, despite the stumbles of some emerging markets in the past few months, over the long term the growth outlook in developing countries remains strong – particularly compared to the long-term outlook in Western economies – and private companies are keen to expand abroad and capitalize on these opportunities. It is this confluence of interests amongst developing country governments, development agencies and MNCs that has sparked this new interest in using development support to catalyse FDI.

There are many different types of projects where development agencies partner with MNCs on investments in developing countries. These include public-private partnerships (PPPs), in which private companies are paid for providing public services; investment guarantees and political risk insurance, in which governments guarantee a private investment against political risks such as expropriation; and equity or co-financing deals in which public agencies directly invest in a project alongside private foreign investors. These deals may be sponsored by traditional aid agencies, development finance institutions and political risk insurers, and regional and multilateral development banks. The goal of the public sector development agencies in supporting such projects are generally first to crowd in private investment into developing countries that otherwise wouldn't occur, for example because political risks are too great; and second (sometimes) to shift the behaviour of MNCs toward better development outcomes, for example by demanding compliance with environmental and labour safeguards.

While such goals align with development agencies' overall missions, there is a need to proceed cautiously in significantly scaling up public support for private FDI. Specifically, in order to ensure these policies deliver development successes, much more attention must be paid to the political and distributional questions inherent in such investments. While both developing country governments and MNCs see potential gains in these deals, it is impossible to ignore the fact that they also have some divergent interests – particularly when projects are in distress or at risk of being cancelled. Public development agencies which are interested in supporting such projects need to pay more attention to these issues, and to develop norms and standards about how to handle the blending of politics and commercial deals.

THE DANGER IN DEALS GONE WRONG: THE CASE OF DABHOL

Sometimes lost in the renewed energy and excitement around public support for private FDI is the reality that this approach to development is not particularly new. Indeed, both bilateral and multilateral development agencies have worked to catalyse private FDI for decades. Though there are many successes they can point to, there are also examples of projects gone awry, including many in which political differences led to protracted investment disputes between MNCs and developing country governments.

One well-known example is the case of the Dabhol power plant, which was built in India by the American companies Enron, General Electric and Bechtel, with financing support from the Overseas Private Investment Corporation (OPIC), the United States political risk insurer, as well as the US Export-Import Bank[3]. Initiated in 1992, the project was at the time the largest ever foreign investment in India; the total project would cost $2.9 billion. Yet the project almost immediately ran into significant problems. In 1995, when the opposition party won regional elections, the new Government announced it would scrap the project. Enron and the Government eventually reached a renegotiated agreement, and the plant began generating power in 1999. Within two years, however, the new deal fell apart. The Government had guaranteed it would purchase the power generated by the plant, but the business plan had dramatically overestimated demand for electricity;

1 Quoted in Shawn Donnan (2015), "Business of saving the poor arrives in Addis Ababa", Financial Times¸ 12 July 2015.

2 Charles Kenny (2015), "Finding Cash for Infrastructure in Addis: Blending, Lending and Guarantees in Finance for Development", CGD Policy Paper 066, June 2015.

3 This description is derived from Kenneth Hansen, Robert C. O'Sullivan and W. Geoffrey Anderson (2005), "The Dabhol Power Project Settlement: What Happened? and How?", available at www.infrastructurejournal.com; Ronald Bettauer (2009), "India and International Arbitration: The Dabhol Experience", The George Washington International Law Review, Vol. 41, pp. 381-387; and Dana Milbank and Paul Blustein (2002), "White House Aided Enron in Dispute", The Washington Post, 19 January 2002, pA01.

this left the Government paying high prices for electricity that wasn't in demand. The Government sought to renegotiate the contract at a lower price, and when Enron refused, it announced it would halt payments; both sides alleged breach of contract, and the dispute quickly escalated in Indian and international arbitration.

Due both to its direct exposure through the OPIC guarantees and because the assets of an American company were at stake, the US Government was heavily involved in trying to enforce a settlement to the dispute, and the issue became an irritant in US-Indian diplomatic relations. Multiple high-ranking US officials, including Vice President Dick Cheney and Secretary of State James Baker, pressed Indian officials to resolve the dispute. The US National Security Council organized a "Dabhol Working Group" to pursue resolution of the issue. Enron President Kenneth Lay publicly suggested that India could face American aid sanctions over the dispute, though the company later clarified that it had not yet asked the US Government to do so. In 2005 the Indian Government finally reached a deal – on confidential terms – with the remaining American investors, which saw ownership transferred to local investors. In the years since then the plant has continued to face financial difficulties, and has operated inconsistently. The project is widely viewed as a debacle by all who were involved.

Dabhol is of course only one example, but it highlights the potential for such publicly-supported foreign investments – even in large flagship projects – to go badly. While at the outset of the project both Enron and the Indian Government were eager to complete the investment, as the project evolved their interests quickly diverged, and through its financial stake the US Government found itself pulled into a bitter political and commercial fight. If public support for private FDI is ultimately going to play a significant beneficial role in spurring development, similar problems will need to be avoided in the future.

THREE POLITICAL QUESTIONS DEVELOPMENT AGENCIES MUST CONSIDER

As development agencies prepare to expand public support for private FDI, they need to look beyond the hype and excitement and remember that the politics of such deals will always be complex, riled with power imbalances and inherent distributional conflicts. After all, we know that negotiations between donors and developing country governments are political, and we know that negotiations between powerful MNCs and developing country governments are political. Bringing all three players into the same project will only multiply these concerns. Getting the politics right, from the outset, is thus crucially important.

As a starting point for creating strategies for managing the politics of such deals, here are three questions development agencies should ask themselves:

1. What role will development agencies play in commercial negotiations between MNCs and developing country governments, and how can they ensure governments negotiate deals that deliver development successes?

While MNCs and developing country governments may both have an interest in launching a certain project, there will still be distributional questions concerning the precise terms of the deal. Firms will want to maximize profits. Developing country governments will want to ensure they aren't overpaying and that firms are contributing to the country's development, for example by creating jobs for domestic workers and protecting environmental resources. In addition to clear distributional issues – for example what price will be paid for electricity in a concession contract – MNCs and states may have divergent preferences over many details of a contract, for example how risk will be shared and what dispute resolution mechanisms will be included. All of these questions will need to be determined by negotiations between the MNC and the host state – and, potentially, the public agency supporting the project.

For a variety of reasons, poor developing countries may face capacity constraints in seeking the best possible legal advice for negotiations with powerful multinational firms, which may keep them from achieving the best possible deals. Development agencies sponsoring these projects should think about how, if at all, they want to support developing country governments in such negotiations.

One option is weighing in directly on the negotiations, to try to secure a development-friendly deal. Yet, given their financial stakes in the projects, development agencies will have conflicts of interest in trying to advise either developing country government or MNCs. Thus, while agencies could use their financial power to veto any deal which is overwhelmingly weighted against either party, they are unlikely to intervene directly in negotiations to slightly tilt the outcome toward the developing country's interests.

Yet there is another option. Recognizing the imbalance poor countries face in negotiations with powerful firms, development agencies could invest in technical assistance to support the negotiating teams of host states where it is needed. A number of groups provide such assistance, including the African Legal Support Facility (ALSF) – an institution hosted by the African Development Bank which provides assistance to African countries to strengthen their legal expertise and negotiating capacity in complex commercial transactions – or the International Senior Lawyers Project, which provides expert pro bono advice on contract negotiations to developing countries.

Importantly, however, it is not always clear how effective these programs are. There is a need for more research to assess under what conditions this assistance makes a real difference in negotiating outcomes, and how best to structure these organizations, for example whether they should have permanent staff or temporary staff, and whether staff should be made up of primarily international experts or local experts more attuned to national circumstances.

2. What level of transparency will be expected in agreements involving private companies, and what are legitimate grounds for exceptions to transparency guidelines?

A second major set of political issues concerns public transparency in agreements between development agencies, MNCs and developing country governments. Both MNCs and developing country governments may have a preference for secrecy in deals; MNCs may want to protect commercial information which potentially could be of some benefit to their competitors, and developing country governments may want to avoid domestic political pressure. Thus there may be pressure to keep the terms of specific deals confidential, rather than making the information publicly available.

Yet greater transparency in public-private development projects would also yield considerable benefits. Transparency of the particular terms of a deal would make it easier for journalists and civil society in the beneficiary country to hold both the government and the firm accountable for their obligations; for example, if a contract commits the MNC to build particular roads or create a certain number of jobs, public knowledge of these obligations can help ensure they're honoured. Moreover, transparency is also important for accountability in the home country of the development agency which is sponsoring the deal, in order to ensure public funds are not being wasted or funnelled to politically-favoured MNCs. The key rationale in public funding of private FDI to developing countries is that the investments would not have been made otherwise; transparency over exactly what benefits MNCs are getting in these deals would help show if this is indeed the case, or if instead public money is simply subsidizing MNC investments in developing countries that would have happened in any case.

The question of exactly how much transparency is optimal is not always straight forward, but development agencies should develop guidelines to establish general principles promoting transparency in their projects involving the private sector. Contracts should be published with as few redactions as possible; if any party to the contract wants to keep certain clauses confidential, they must clearly articulate why this is necessary. Transparency need not – and in most cases probably should not – be absolute; for example it would likely be counterproductive to demand full transparency during negotiations of a deal, inhibiting the back and forth of offers and counter offers[4]. But a general presumption of transparency – alongside clear guidelines on when this presumption should be overruled – would help maximize the development benefits of publicly-supported private FDI projects in developing countries.

3. Under what conditions should the agency apply political pressure to the host state government to resolve potential disputes, and what political remedies can be legitimately used to support commercial transactions?

As with any foreign investment project, there is the possibility that publicly-supported FDI projects will result in disputes between investors and the host state government. When such disputes occur, development agencies – both bilateral and multilateral – may face requests from investors to intervene diplomatically with the host state to seek a resolution. For example, both OPIC and the Multilateral Investment Guarantee Agency (MIGA), an arm of the World Bank which provides political risk insurance, advertise their ability to convince host state officials to resolve disputes and keep projects on track; this is a key selling point for investors considering purchasing political risk insurance.

Such interventions raise the question of under what conditions the political power of the development agency's home state (or international organization) can be legitimately deployed to advance commercial interests, and what forms of diplomatic pressure can be legitimately used in these cases. As with transparency, this is a nuanced issue which is open to debate. A military intervention to demand a host state repeal a new tax would clearly violate established diplomatic norms; a phone call to a minister protesting against an expropriation would not. In between lies a wide range of possible diplomatic interventions, about which actors may disagree which are legitimate and which are not.

Two cases from MIGA help illustrate the point[5]. In Moldova, a MIGA-backed Spanish company was being pressured to sell its assets to a Russian competitor; both the President of the World Bank and the Prime Minister of Spain intervened

4 For a similar argument, see Simon Lester (2015), "Transparency in Trade Negotiations: How Much in Enough, How Much is Too Much?", ICTSD Bridges Africa, Volume 4, Number 7, 1 September 2015.

5 Both are described in Nathan Jensen, Noel Johnston, Chia-yi Lee and Abdulhadi Sahin, "Crisis and Contract Breach: The Domestic and International Determinants of Expropriation", 2014 Working Paper.

directly, including an explicit threat to cut off financial support from the World Bank, the International Finance Corporation (IFC) and European Bank for Reconstruction and Development. Similarly, in a case involving a foreign cell phone operator in Benin with MIGA political risk insurance, the World Bank threatened to cut off future grants to the country unless a dispute surrounding new fees for the phone operator was resolved. Are these examples of MIGA intervening to successfully resolve disputes and preserve the development benefits of foreign investments, or are they examples of developing countries being coerced into policies which favour foreign investors simply to preserve commercial gains? The answer is not immediately clear.

Development agencies – individually or, preferably, collectively – should develop and publicize clear guidelines concerning how they approach these issues. What host state actions are so egregious they warrant the threat of cutting off substantial aid or trade benefits? What other forms of diplomatic pressure can be legitimately deployed in investment disputes? Clear, ex ante guidance on these issues will help set the terms of debate for all players involved: MNCs will know what they can (and can't) ask for, and host states will know what diplomatic threats are real and which – such as that by Enron discussed above – are bluffs. Most importantly, development agencies themselves will have guidance on how to deploy political pressure in varying situations, rather than making ad hoc decisions, which are more likely to be swayed by a particular politician's opinions or pressure from a powerful private company.

CONCLUSION

When development agencies provide financing or guarantees for private FDI projects in developing countries, they gain leverage in the project – across all stages of the investment, from negotiations to operations to (the possibility of) dispute resolution. Every decision to either use or not use this leverage is political.

There are few simple or straightforward answers to these issues. The political challenges inherent in public support for private FDI projects can never be eliminated, but they can be managed better or worse. The first key step is to frankly and transparently acknowledge these political and distributional divides, and to move beyond rhetoric that all of these investments are idyllic win-win projects. Development agencies should identify clear principles to guide policymakers in navigating these complex political questions. It is important to do so as soon as possible, as public support for private FDI appears likely to increase substantially in the coming years.