Vanderbilt Journal of Transnational Law

Volume 7
Issue 2 *Spring 1974*

Article 3

1974

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THE EVOLUTION OF CONCESSION AGREEMENTS IN UNDERDEVELOPED COUNTRIES AND THE UNITED STATES NATIONAL INTEREST

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I.

Large natural resource projects in underdeveloped countries provide great benefits to United States investors, to host countries and to the United States itself. Yet concession agreements to exploit natural resources are notoriously controversial and notoriously unstable. This article will examine the United States national interest in guaranteeing equity investments in foreign natural resource development and will argue that concession agreements in large natural resource projects in the developing world go through a highly predictable evolution, reflecting changes in the relative bargaining positions of the foreign investors and the host governments. Initial agreements reflect the foreign company's quasi-monopolistic control over the skills necessary to bring a major operation on-line, and reflect a heavy discounting for the risk of failure. The initial agreements may also reflect the host country's ignorance of industry practices, and of international tax and accounting procedures. The result is that almost all large natural resource concessions appear, after the fact, to have been written with terms highly favorable to the foreign investor.

If the project is unsuccessful, the same or greater enticements will be necessary to attract other investors. But if the project is successful, the whole atmosphere surrounding the bargaining situation begins to change. A gamble with large risks has been won, and the host government is unlikely to want to keep paying for long a premium that reflects those risks. In fact, for a host country observing a foreign operation successfully producing a large flow of revenue to the parent company, it may be politically impossible

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not to revise the terms of the initial concession. Clearly, the balance of power that started with a steep tilt in the direction of the foreign investor has now shifted to a tilt in the direction of the host country. Empirically, very few large-scale successful concession agreements in underdeveloped countries have remained long unaltered.

Just before new foreign corporate commitments are sought, the balance of power is weighted heavily toward the foreign investor and terms are dictated largely along lines that he chooses. After each foreign corporate commitment is begun, the balance of power begins to shift back in favor of the host country and prior terms are renegotiated.

Whether one likes it or not, the negotiation and renegotiation of large concession agreements is a "political" process reflecting the relative bargaining strengths of foreign investor and host country. In transactions in which there are such abrupt shifts in the balance of power, the idea of a "sacred contract" with "inviolability" stretching typically 20 or 40 or 99 years into the future is peculiarly inappropriate. There is a continuing play of pressures from both sides to rearrange terms a little more to their own benefit. To argue that there should not be such a play of pressures, because of the "sanctity" of the original contract, is only to argue that agreements should always be frozen (and implicity enforced) on terms very favorable to the foreign investors.

Not mysteriously, foreign investors respect contracts that are inevitably written heavily in their favor. There should be no mystery why host governments may try to "readjust" contracts, when possible, in their own favor. The so-called "bursts or waves" of emotion and economic nationalism are no less "rational" ways of testing the strength of the country's bargaining position than the formal contracts with the ritual 20, 40 or 99 year guarantees of "inviolability" are a way of celebrating the foreign investors' moments of strength.

In fact, the game of joint-maximization played in foreign investment is a process of on-going mutual adjustment in which the foreign investors act in accord with their own best interests when they are in the strongest position and accede to necessity when they are weak and exposed, while host governments accede to necessity when they are weak and act in accord with their own best interests as they gain strength.

The problem with this process, however, is that it generates extraordinary levels of tension and extreme perceptions of injustice and exploitation. The initial concession agreements, once successful, always look in retrospect like cases of the strong cheating the weak, and political groups in the host country can generate great campaigns from this perception. The renegotiation process, in the perception of the foreign investor, represents the host country (now strong) beginning to cheat him (now weak) and he can generate campaigns of his own on this issue.

Some of the tensions that ensue are inevitable, and are independent of the character of the actors involved. A corporate board of directors—no matter how careful to observe its role as a "good corporate citizen" overseas—would consider itself irresponsible if it did not take advantage of its bargaining strengths. A host government—of its own accord or under pressure from political opponents—would consider itself irresponsible if it did not take advantage of its bargaining strengths.

The task of United States policy should be to move in the direction of preserving the benefits obtained from foreign investment in underdeveloped countries while minimizing the tensions that are generated in the process.

This paper will suggest that the practice of guaranteeing American equity investment probably[1] has the effect of exacerbating the tensions involved and hindering experimentation with new kinds of arrangements between American companies and host countries that might produce the same benefits with fewer political and economic costs.

The inappropriateness to this kind of project of the straight equity investment via the long-term concession contract (with or without United States backing) does not preclude such ventures from being carried out in an orderly and relatively dependable fashion with attractive returns to all concerned. Examples of alternative arrangements—management contracts, service contracts, debt funding, factoring, equity investment with options for systematic divestment—will be introduced to show how they might better conform to the course that the foreign company-host country relations will follow anyway. Many large American corporations now act in essentially a service-management capacity in Latin America, Africa and South Asia to supply raw materials on

1. It should be emphasized that there has been no definitive survey to test these propositions—nor could there be as long as the United States investment guarantee program continues to function.

contract to European and Japanese processors and consumers, yet the American companies are the target of nationalistic attacks because they have formal ownership through a relatively small equity investment, while the Japanese and Europeans are seen as the benevolent suppliers of markets for the output.

The ideal would be a shift toward more flexible arrangements in which the expectations of both sides include those abrupt swings in the balance of power and in which both sides have an interest in keeping those swings within the margins agreed to in advance. This would be a step in the direction of the Calvo Doctrine, by which United States companies and the United States Government could give up reliance on the threat of a Big Stick in the background (whether exercised unilaterally or via multinational agencies) that the host countries find intolerable and the companies find ineffective.

Clearly, a shift away from equity investment in general, and away from United States Government-guaranteed equity investment in particular, will not solve all the problems of American businesses overseas. No cosmetic repackaging of the contributions of American companies will make certain zero-sum disputes about the distribution of benefits disappear, even if the repackaging does manage to do away with some of the tense issues of "sub-soil rights," "foreign ownership" and "foreign control." In fact, there is evidence to indicate that a shift away from direct ownership on the part of American businesses overseas may add some real economic costs to host countries.

The gains, however, will show up in a diminution of unproductive disputes about whether a course of foreign investor-host country relations that is empirically inevitable is morally just.

Finally, this paper offers the suggestion that a more flexible approach to the form in which large natural resource projects are negotiated might have diplomatic benefits as well. The United States would find itself less frequently locked with inflexibility ("unintentionally," "bureaucratically," "legalistically") into defending a contract in an underdeveloped country that no identifiable United States policy-maker believes is in the national interest.

II.

How should one approach the problem of trying to understand the tensions that are generated between host countries and large natural resource companies?

Most businessmen and economists use game theory and bargaining models, especially the bilateral monopoly model, as a framework for analyzing foreign investor-host country relations.[2]

The foreign investor has resources, skills, experience and access to markets and finance that the host country needs to develop its resource base. The country has the mineral wealth, the labor force and the control over taxation that may be mixed in some proportion to produce an attractive opportunity to the investor. Unless the host government loves foreign investors no matter how they behave, on the one hand, or is anxious to keep foreigners out no matter what the cost, on the other, then the terms under which a foreign investor will be allowed to enter the country and operate there constitute a problem in joint-maximization.

As both the foreign investor and the host government try to increase their returns from the industry, each side has threats to make and benefits to offer. The struggle centers on the relative distribution of revenues that are being generated or that potentially could be generated in the industry. This is not a zero-sum game since the absolute level of returns is a function of the relative shares. Some kinds of collaborative strategies can increase the size of the pie to be divided and increase the absolute returns to all parties. The host government must weigh the benefits of demanding a larger share of the existing revenue against the prospect of a large absolute amount (but a smaller share) of revenue if the investor can be induced to expand operations. The foreign investor must weigh his prospects for further profits on the original investment against the chance for larger profits on expanded operations.

This kind of explicit bargaining generally characterizes relations between the large American natural resource companies and various host governments each time major new corporate commitments are sought.

But the conventional framework of game theory or bargaining models is not dynamic enough to show underlying trends or cycles

2. *Cf.* FOREIGN INVESTMENT IN THE PETROLEUM AND MINERAL INDUSTRIES: CASE STUDIES IN INVESTOR-HOST COUNTRY RELATIONS (R. Mikesell ed. 1971) [hereinafter cited as R. Mikesell]; C. KINDLEBERGER, AMERICAN BUSINESS ABROAD (1969); C. KINDLEBERGER, ECONOMIC DEVELOPMENT (2d ed. 1965); E. PENROSE, NEW ORIENTATIONS: ESSAYS IN INTERNATIONAL RELATIONS (1970); T. SHELLING, THE STRATEGY OF CONFLICT (1963); G. STIGLER, THE THEORY OF PRICE (1966); Penrose, *Profit Sharing Between Producing Countries and Oil Companies in the Middle East*, 69 ECON. J. 238 (1959).

in bargaining strength. To understand why natural resource concessions[3] in underdeveloped countries are so unstable and so controversial, it is necessary to formulate some idea of the evolution of the balance of power between the foreign investor and the host government.[4]

First, the characteristics of the typical project[5] in oil, for example, or natural gas, should be examined. The typical natural resource project involves a large, discrete, lump-sum investment with a long gestation period, a high ratio of fixed to variable costs, and little opportunity for incremental adjustments of output at the margin. Despite costly surveys, test drillings and feasibility studies, little valuable information can be learned about final production costs on the whole project until it is actually on-line. Often operating in the most inhospitable regions imaginable, the large natural resource investor does not begin to get any meaningful return from his investment until the hole is dug or drilled, the mill or refinery is erected, the railroad built, the port constructed and

3. The generic term "natural resource concessions" is used here even though many countries call the agreements by some other name. What is meant is that there is a special category of activity associated with the primary export sector—a special tax regime, a special import arrangement, a special juridical category for "subsoil rights," frequently a special foreign exchange arrangement, and a special regulatory agency—corresponding to the "sensitive" status that the sector occupies in the life of the host country and not covered under the laws of general application.

4. For a development of this approach see R. VERNON, SOVEREIGNTY AT BAY: THE MULTINATIONAL SPREAD OF U.S. ENTERPRISES (1971); Vernon, *Long-Run Trends in Concession Contracts*, 1967 PROC. AM. SOC'Y INT'L L. 81. *See also* Moran, *Politics of Economic Nationalism and the Evolution of Concession Agreements*, 1972 PROC. AM. SOC'Y INT'L L. 216; Moran, *Pulling, Pushing, and Shoving: A Model of the Dialectics of Foreign Investment*, in COUNCIL ON INTERNATIONAL STUDIES (1972); L. WELLS, THE EVOLUTION OF CONCESSION AGREEMENTS (ECON. DEVELOPMENT REP. NO. 117, 1969).

5. This model most accurately corresponds to natural resource oligopolies when the largest barriers to entry exist at the production stage. In other natural resource industries in which the barriers are located in processing or marketing farther downstream outside the immediate reach of the host government—in aluminum or tropical agriculture, for example—the investor has more alternatives for protecting himself against the challenge of economic nationalism.

The model can also be easily modified to cover other industries in which investments can be introduced incrementally and uncertainty reduced at less cost—such as in most manufacturing industries.

hundreds of millions of dollars completely sunk and gone. In short, he must make a substantial commitment under conditions of great uncertainty with little opportunity to test or adjust incrementally.

What does this mean in initial bargaining terms between the host country and the foreign investor?

When a representative of Anaconda, Jersey Standard or Bethlehem Steel walks into the presidential office of a small underdeveloped country and announces, say, that he has plans to build a 100,000-metric-ton-per-year copper mine if the president is interested, he holds at this point all the cards in his hands. The foreign mining company enjoys near-monopoly control over the resources and the knowledge that the host country needs to develop a major tax-producing, foreign exchange-producing, employment-producing operation—a monopoly control that only a few fellow oligopolists could supply at broadly similar prices.

The host country, for its part, is able to evaluate the location and value of potential mineral deposits even less adequately than the foreign investors. Consequently, no matter what the ideological complexion of the government, no matter whether the host government is composed of fierce nationalists or of weak bribe-takers, the host country must initially accept terms heavily weighted in favor of the foreign investor or end up with nothing at all.

And no matter how "nice" an investor the foreign company is, no matter how much of a "good corporate citizen," he would consider himself irresponsible to commit such a large sum of money with such high risks unless the incentive of a potentially high rate of return were promised. Thus, writers who stress that behavior as a good corporate citizen can alleviate the tension generated by the investment process would have a very weak case with large natural resource concession agreements since the extreme disparity of bargaining power will exist at the initiation of any concession agreement, independent of the character of the bargainers.

The result is that new concession agreements in natural resource industries invariably seem to have been written along lines largely dictated by the foreign investors with the length of the contract typically set at 20, 40 or 99 years.

III.

But there is a dialectic in the balance of power between the foreign investor and the host country that does not stop when the investment is sunk. If the investment is made and is unsuccessful, the foreigner has taken his risk, has lost his bet, and can share his grief with the Internal Revenue Services of the countries where he operates. Other investors would need the same or more generous treatment to make another try. But once an investment is made and the operation is a success, the terms of the situation totally change. Uncertainty is reduced, and the old doubts are forgotten. In the natural resource field, uncertain investments are frequently turned into quite lucrative operations. The host government gazes out at the profitable operation carrying off resources the country was sure it had all along, with a large share of the revenue flowing away to foreigners. The foreign investor has made his bet and won, but the host government is unlikely to want to keep paying on the ticket in perpetuity. The premium paid to the foreign investor year after year is likely to seem, in retrospect, too high, and the government in power is likely to argue at some point that the country is being exploited. If the government in power does not draw that conclusion, its political opponents will.

The host country perception of being exploited, like the foreign company perception of being cheated when contracts are broken, emerges almost irrespective of what the actual figures are that divide profits between host government and foreigner. To take an example from the history of the copper industry in Chile,[6] various administrations in Santiago over the course of the past half century have looked back five to ten years later on negotiations that had reduced the tax rate[7] on Anaconda and Kennecott to 18 per cent, to 33 per cent, to 55 per cent and to 60 per cent, and in each case drew the same conclusion—that the country had gotten the rotten end of the deal. Forced into renegotiation, the North American companies saw their average annual return on investment re-

6. For the history of Anaconda and Kennecott in Chile see M. MAMALAKIS & C. REYNOLDS, ESSAYS ON THE CHILEAN ECONOMY (1965); R. Mikesell, *supra* note 2, at 7; T. MORAN, EL COBRE ES CHILENO: THE MULTINATIONAL CORPORATION AND THE POLITICS OF DEVELOPMENT: THE CASE OF COPPER IN CHILE 1945-1972 (Harvard Univ. Center for Int'l Affairs, 1973); A. PINTO, CHILE: UN CASE DE DESARRELLE FRUSTRADE (Editorial Universitaria, Santiago 1959); A. PINTO, HACIA NUESTRA INDEPENDENCIA ECONÓMICA (Editorial del Pacifico, Santiago 1953); M. VALENZUELA, LAW POLÍTICA ECONÓMICA DEL COBRE EN CHILE (Universidad de Chile, Santiago 1961).

7. The swing of loosening and tightening terms in concession agreements usually applies simultaneously to rates of depletion and depreciation, exchange convertibility, repatriation of profits, import privileges, and so forth.

duced at various times to 35 per cent, 25 per cent and 15 per cent and felt that they were being unfairly treated.

The long-term concession contract is a uniquely inappropriate means of establishing expectations about the relations between host countries and foreign investors. Once the uncertainty has been dispelled and the risk reduced, the terms of the concession no longer correspond to the "realities" of the situation. Almost all successful natural resource contracts look, after the fact, like unjust treatment of the weak by the strong. In a certain sense, this is true—since concession contracts are always written in terms very favorable to strong foreigners. To follow a purely legalistic course—to uphold the principle of "sanctity of contract" in a situation in which fluctuating risk and uncertainty mean that *ceteris* do not long remain *paribus*—is in effect to affirm that agreements should always be frozen in terms very favorable to foreign investors.

Accompanying the changing perception of justice, however, is a shift in the balance of power toward the host country. Once the foreign company has sunk its capital, it will continue to run a successful operation even though its share of the revenues might be reduced. In contrast to its prior weakness, the host country now begins to have good cards in its hands. A sense of being exploited by foreigners and the power to do something about it are an explosive political combination. Effective pressures for "renegotiations," "surtaxes," "recomputations" or "adjustments" to reflect the shift in bargaining strength from the foreign company to the host country[8] can easily be mobilized. Empirically, since the end of the Second World War, few successful concession agreements in developing countries—in ferrous and nonferrous metals, petroleum, sulphur and natural gas—have remained long unaltered.[9]

8. In addition, each time that mines or wells are successfully brought on-line, uncertainty about the existence of subsoil wealth and about the structure of production costs has been reduced for subsequent investors. The host government is able to drive a tougher bargain with later entrants, and this in turn increases the pressure to revise the original contracts to be more in line with the later agreements.

9. For case studies see E. LIEUWEN, PETROLEUM IN VENEZUELA: A HISTORY (1954); E. LIEUWEN, VENEZUELA (1965); R. Mikesell, *supra* note 2, at 29; Z. MIKDASHI, THE COMMUNITY OF OIL EXPORTING COUNTRIES: A STUDY IN GOVERNMENT COOPERATION (1972); T. MORAN, *supra* note 6, at 29; E. PENROSE, THE LARGE INTERNATIONAL FIRM IN DEVELOPING COUNTRIES (1969); M. TANZER, THE POLITICAL

Under the pressure of "nationalistic" governments of various ideological hue, they are sooner or later renegotiated.

IV.

Theoretically, the swing back and forth in the balance of power could continue indefinitely. But the experience of most developing countries with a rich natural resource endowment is better represented by introducing the idea of a learning curve on the part of the host country.

A country that has no history of large natural resource concessions probably begins with a very inexact knowledge of the extent of its mineral or petroleum wealth and is in an inferior position to the foreign investor to conduct independent explorations or make reliable feasibility studies. There has been no occasion to build up a bureaucracy with skill in analyzing proposals for natural resource development. In many cases host governments are not initially familiar enough with transnational corporate accounting, with international tax provisions or with terms of concessions in other countries to make a negotiation process very meaningful.

In much of the Third World before the Second World War, even in regions not formally colonized, initial investments in resource extractions were undertaken with only the most primitive attempts at bargaining. When the international oil companies first approached General Vincente Gómez of Venezuela or King Ibn Saud of Saudi Arabia, they were invited to draft their own petroleum legislation.[10] The early international investments in tin, bauxite, zinc and iron ore were made under much the same conditions. The possibility of earning foreign revenues from unknown mineral deposits appeared as a windfall and primitive forms of tax collection, frequently royalty payments, were the reward collected

ECONOMY OF INTERNATIONAL OIL AND THE UNDER-DEVELOPED COUNTRIES (1969); R. VERNON, *supra* note 4, at 29; Barnes, *International Oil Companies Confront Governments: A Half-Century of Experience*, 16 INT'L STUDIES Q. 454 (1972); Vernon, *supra* note 4; L. WELLS, *supra* note 4, at 29.

10. *Cf.* E. LIEUWEN, PETROLEUM IN VENEZUELA: A HISTORY, *supra* note 9, at 30; E. LIEUWEN, VENEZUELA, *supra* note 9, at 30; Edwards, *Foreign Petroleum Companies and the State in Venezuela*, in R. Mikesell, *supra* note 2, at 101; Harris, *The Impact of the Petroleum Export Industry on the Pattern of Venezuelan Economic Development*, in R. Mikesell, *supra* note 2, at 129; Moran, *The Politics of Oil: Coups and Costs*, [1972] FOREIGN POLICY 129; Wells, *Aramco: The Evolution of an Oil Concession*, in R. Mikesell, *supra* note 2, at 216.

by governments ill-equipped to judge adequately how far they could push against the companies.[11]

Successful ventures, however, provide an incentive for the host country to develop a bureaucracy with skills and expertise appropriate to the industry. From a very low position, the country starts to move up a learning curve in analyzing proposals, accumulating experience in monitoring corporate behavior and acquiring knowledge about the dynamics of the industry.

The incentive to chip away at the foreigner's monopoly on skills and expertise is magnified as demands for a larger share of the revenues grow and as claims on those revenues multiply. When the oil companies first established themselves in the Middle East, the fiscal needs of the host governments were little more than the personal expenses of their followers and the patronage of their political clientele. But as the Second World War and decolonization brought social mobilization,[12] urbanization and import-substituting industrialization to these regions, the necessity of thinking in terms of maximizing revenues from resource extraction began to become a crucial political issue. Even those governments most effectively manipulated by the foreign companies were not immune to such pressures.[13] After Premier Mossadegh nationalized the Anglo-Iranian Oil Company in 1951 to finance the First Iranian Development Plan, he was overthrown. But state revenues from the petroleum sector have not stopped rising, nor have domestic pressures allowed them even to remain level for any two-year period since the subsequent agreements with the Iranian Oil Consor-

11. Royalties—or excise taxes—in oil exporting countries now, however, play a special role in oligopoly discipline. Taxes per barrel—royalties or excise taxes in fact even though they may be income taxes in form—are at the present time negotiated jointly by the Organization of Petroleum Exporting Countries to provide a tax floor above which the market is allowed to allocate production shares on the basis of operating costs. In the absence of the power to set production quotas for individual countries directly, then, taxes per barrel is the method by which the producing countries discipline each other in restricting production. *See* M.A. ADELMAN, THE WORLD PETROLEUM MARKET (1972).

12. For the literature on social mobilization see S. HUNTINGTON, POLITICAL ORDER IN CHANGING SOCIETIES (1968); Deutsch, *Social Mobilization and Political Development,* 55 AM. POL. SCI. REV. 493 (1961); Olsen, *Rapid Growth as a Destabilizing Force,* 23 J. ECON. HISTORY 529 (1963); Tanter & Midlarsky, *A Theory of Revolution,* 11 J. CONFLICT RESOLUTION 264 (1967).

13. *See* Bartsch, *The Impact of the Oil Industry on the Economy of Iran,* in R. Mikesell, *supra* note 2, at 237. *See also* materials cited note 10 *supra.*

tium were renegotiated in 1954. The profit split between Iran and the Consortium climbed from 68 per cent/32 per cent in 1954 to about 80 per cent/20 per cent by 1970. In Venezuela, even the dictator (General) Pérez Jiménez, who overthrew the more "nationalistic" Rómulo Betancourt in 1950 with the promise of helping the foreign oil companies, found that he constantly needed more revenues to finance urban construction and industrial growth. He provoked a crisis in the international industry in 1956 by cancelling options given in earlier contracts to the foreign companies and auctioning off large concessions to new companies more willing than the old ones to expand production. Successor governments in Venezuela pushed the host country share of petroleum revenues above 70 per cent in the 1960's with a national commitment to "sow the petroleum" for development. The value of incremental revenues to sustain growth or to dissipate social tensions in countries that are undergoing rapid development and social mobilization is too high and the political temptation too great to allow foreign companies a stable existence.

The very importance of the foreign-controlled industry to the social and economic welfare of the host country renders it inseparable from issues of national sovereignty.[14] To return to the example of copper in Chile, for four decades the pace and direction of national development in that country have been dictated by the performance of Anaconda and Kennecott. Copper has constituted as much as 80 per cent of Chilean exports and has provided the bulk of the government's hard currency revenues. To put the importance of the industry into perspective, one might consider the following: all of *Fortune's* 500 largest United States corporations combined do not approach the role in the economy of the United States or pay more than a fraction of the percentage of United States taxes that Anaconda and Kennecott alone supply for Chile. All the ranches in Texas, the banks in New York, and the aerospace industry in the Northwest are not as responsible economically for the fate of their respective states as the copper industry is for Chile.

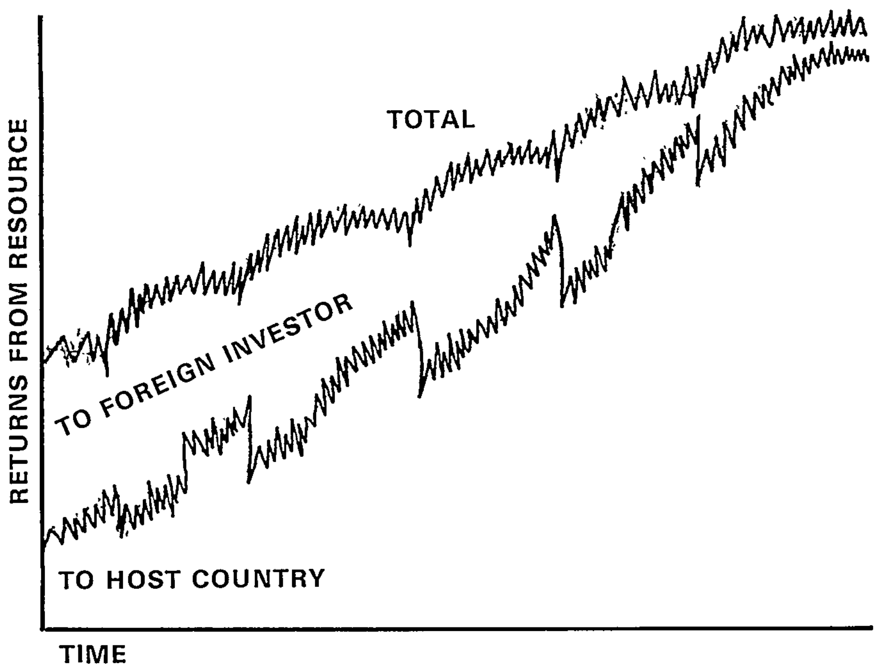
To have the copper industry run by self-appointed and self-

14. Issues of sovereignty are heightened in natural resource industries in many countries because of legal traditions in which subsoil rights are regarded as the inalienable patrimony of the nation over which the government does not cede ownership but merely grants privileges of exploitation.

perpetuating foreign groups according to strategies based on their own internal corporate needs must easily be seen as a threat as well as an insult to national dignity. The threat exists even without emphasizing the possibility, which no Chilean (or Iranian or Venezuelan) can afford to ignore, that the foreign managers may be intimately linked to hostile intelligence agencies, as in the International Telephone and Telegraph episode in Chile. A natural mistrust of concentrations of power, especially concentrations of foreign power, in an area so vital to national development, means that there will be a preference for domestic control and a probable consensus to pay some price for domestic control.[15]

Thus, as a developing country moves up a learning curve of bargaining skills and supervisory skills, the relations with foreign investors do not merely swing back and forth. Rather, those relations look more like the schematic representation in Diagram One.

DIAGRAM ONE



Note: since returns are a function of final market prices, the curves will not be smooth.

15. For this approach to the analysis of economic nationalism see ECONOMIC NATIONALISM IN OLD AND NEW STATES (H. Johnson ed. 1967); Breton, *The Economics of Nationalism*, 72 J. POL. ECON. 376 (1964); Johnson, *An Economic Theory of Protectionism: Tariff Bargaining, and the Formation of Customs Unions*, 73 J. POL. ECON. 256 (1965).

At the extreme right end of the curve, the country may acquire the skills to operate the industry directly. What may have begun as only a rhetorical dream of "recovering control of the natural wealth" and "restoring sovereignty over national development" may come at last within the reach of the host country.

Such an outcome cannot, however, be predicted clearly in advance. From the beginning to the end, the way in which the changing balance of power will be manipulated is a function of the perception of the advantages that the foreign management is contributing to the performance of the industry or a function of the perception of the cost of replacing or doing without those advantages.

V.

Some host countries may diversify exports sufficiently so that they no longer depend on one or two foreign-dominated industries for growth and development. Foreign investment in natural resource development then might decline in public prominence to a sufficient extent to permit local authorities to treat such projects under the commercial laws of general application in the country. Alternatively, host country nationals might enter the industry in sufficient strength to produce the same effect. This would be one scenario in which relations between the foreign investor and the host country would move easily and spontaneously away from the tensions associated with the balance-of-power bargaining paradigm.

Other countries may find formulas for hiring scarce foreign talents in such a way that many of the tensions of "foreign ownership," "foreign control," "sub-soil rights" and "threats to sovereignty" do not arise. Management contracts, service contracts and joint ventures (with majority ownership by local government agencies or host country nationals)[16] may be a more palatable way of obtaining foreign services without creating political reaction than is direct foreign ownership via (United States Government guaranteed) equity investment. In this scenario repackaging the relations

16. The rationale for joint ventures is that local partners presumably will fight for accounting practices, financial practices and pricing practices that will make the highest profits possible show up within the taxing jurisdiction of the host country. A counter-argument is frequently advanced, however, to the effect that local partners become an elite interest group fighting against the public interest for favorable treatment for the foreign investors.

between foreign companies and the host country would not necessarily eliminate constant adjustments according to relative bargaining strengths but might keep such adjustments within limits more tolerable to the expectations of both sides. The foreign company would be paid directly, and perhaps handsomely, for services rendered and need not create an operation on its own from whose ownership it then expects to collect a stream of rents in perpetuity.

Finally, some countries (and some companies) may find direct investment via equity ownership to be the only feasible means of setting up a natural resource enterprise—even though both sides realize that this places the foreigner in a politically and economically sensitive position. The foreign investor is welcomed into the country only because he possesses some quasi-monopolistic advantage that cannot be transferred any other way. The burden will fall on him, if he chooses to occupy the exposed position, to demonstrate that his presence continues to offer clear advantages that would be very costly to the country to replace or do without.

Doubtless there are many corporations whose expertise is so valuable and tightly held that they can occupy reasonably unassailable positions as the balance of power swings back and forth for long periods of time. And doubtless there are some corporations that are willing to respond to the challenge of nationalism by bringing more and more resources to the service of the country for a considerable period of time. Even in these cases, however, it would be wise to introduce into the expectations of both sides an anticipation of swings in the pendulum of power, including a possible final swing in the host country's favor when the domestic benefits of nationalization finally appear to outweigh the costs of doing without the foreigner. The foreign corporation, as well as the host country, may discover the value of thinking seriously about introducing into the initial negotiations[17] an option of systematic divestment[18] with the margins of compensation agreed to in advance. To protect such an

17. One corporate argument against the option for systematic divestment in natural resource oligopolies is that they will lose control over the ability to coordinate production. But there is no reason why a goal of United States public policy should be to support the power of oligopolies to exact a rent from final consumers through restricting output.

18. *Cf.* A. HIRSCHMAN, *How to Divest in Latin America, and Why*, in A BIAS FOR HOPE: ESSAYS ON DEVELOPMENT AND LATIN AMERICA (1971).

agreement, perhaps, a certain sum from taxes or from depletion/depreciation, or both, could be put in escrow in the hands of an independent third party. This would spread the risk of nationalization between host country and foreign investor while insuring that successor governments would bear identical costs (namely the loss of the services of the foreigner plus the loss of the amount agreed to as compensation) if they chose nationalization.

The aim of United States Government policy should be to encourage arrangements that maintain or increase the benefits generated by the overseas operations of American companies, that eliminate or minimize unproductive tensions and disputes about foreign ownership, and that anticipate and deal realistically with the course that foreign company-host country relations are bound to follow. Both companies and countries should be stimulated to recognize and deal creatively with the tensions they cause each other, and to experiment with agreements that each has an interest in maintaining.

Much tiresome prose is spent asking rhetorically whether there is an "essential" community of interest between foreign investors and host countries, or an "essential" conflict of interest. What is needed is an effort to bring the real community of interest between foreign investors and host countries to bear in working out methods of adjusting for the real conflicts of interest.

It is not unreasonable to suggest that the policy of giving United States Government guarantees to direct equity investment in natural resources runs directly counter to encouraging these creative arrangements. Why should the management of a United States corporation waste valuable time and effort experimenting with ways to spread risk and avoid potential disputes sometime in the future when the United States Government stands ready to assume the burden of the investment risk and become a party to disputes at any point defined by the company? The saving grace of the government guaranteed investment policy posture in the past is that it has been notoriously ineffective, and has been so recognized by the more agile and perceptive executives in the American business community.

In the past decade, these executives have increasingly been experimenting with ways of spreading risk among final consumers, host governments, financial intermediaries and themselves.[19] More

19. *Cf.* Moran, *Transnational Strategies of Protection and Defense by Multi-*

and more capital for natural resource development has been raised in advance from processors and consumers, from financial institutions through various kinds of factoring (that is, selling collection rights to long-term contracts to a financial intermediary at a discount) or from host country participation. There are currently many American companies in South Asia, Africa and Latin America that went into business only after processors or customers in Japan or Western Europe advanced them money for contracts for output stretching to the end of the life of the mine or the well.[20] In relation to traditional practices, they have high debt-to-equity ratios in which perhaps only about fifteen per cent of the risk capital was raised in the name of the American parent.

Yet the equity is owned by the American parent, frequently with a guarantee from the United States Government. The company is the actual or potential target of nationalistic attack. And the United States Government is the "imperalistic power" liable to become drawn into a diplomatic dispute, directly or via multilateral lending agencies, with the host country.[21] The Japanese or West European consortia for whom the American mining or drilling companies are working on what amounts to a service contract are viewed, meanwhile, as providing kindly access to final markets.

In view of the successful experimentation that American companies have begun to spread their financial risk, it seems reasonable to predict that they would be equally imaginative in working out new arrangements to avoid the tensions of direct ownership if they did not have the large disincentive provided by the United States guarantee program.

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national Corporations: Spreading the Risk and Raising the Cost for Nationalization in Natural Resources, 27 INT'L ORGANIZATION 273 (1973).

20. This does not imply any inside knowledge of the corporate arrangements. One can follow the details of such arrangements in such journals as *The Engineering and Mining Journal,* the *Petroleum Press Service,* and the annual reports of the major natural resource companies.

21. The movement of the Nixon administration away from dealing with disputes involving United States companies overseas through such threats as that of the Hickenlooper Amendment toward votes against loans from multilateral lending agencies will serve the purposes suggested here only if it is in effect a signal to United States investors that they can expect no effective help from the United States Government. Otherwise, it is just as counterproductive as the old interventionism while being even less effective.

It should be emphasized that novel arrangements would not necessarily be less costly to host countries, in purely financial terms, than the traditional arrangements are now. (Indeed, by having to bear new costs, host countries may come to appreciate the benefits of the old system.) Host countries may have to supply more of the venture capital for new projects, or, if the host states try to raise capital by selling long-term contracts, they will find that the cost is quite high. To make their agreements on compensation credible, host countries may have to forego some tax revenue or post a lump-sum bond. They may have to bear more of the burden of risk of failure of new projects and not be able to share it with or push it off on the foreign companies. They may find that operating at arms-length with foreign companies on service or management contracts is more, not less, costly than the system of direct foreign investment. They may discover, as the evidence indicates,[22] that jointly owned subsidiaries (especially when the host government or host country nationals are majority partners) are charged a higher proportion of common overhead expenses by the foreign partner's parent than wholly owned subsidiaries. Finally, they may come to realize that dependence on a distant impersonal market price for selling their output may be no more helpful to their balance of payments problems and developmental aspirations than the transfer prices of vertically integrated foreign corporations—even though the challenge to national sovereignty seems less.

The benefits will come through avoiding the major breakdowns and major losses that occur through acrimonious nationalizations, sudden expropriations and destructive waves of economic nationalism. A realistic approach to accommodating the challenge of economic nationalism can reduce the uncertainty and hence the costs borne by all sides in the production of natural resources.

VI.

To the economic savings should be added diplomatic benefits as well. Given the dialectical relations between foreign investors and

22. J. STOPFORD & L. WELLS, MANAGING THE MULTINATIONAL ENTERPRISE (1973); R. VERNON, *supra* note 4; Franko, *Strategy Choice and Multinational Corporate Tolerance for Joint Ventures with Foreign Partners* (D.B.A. dissertation, on file at the Harvard Univ. Graduate School of Business Administration, 1969).

host countries, there would be political as well as economic profit in making a virtue of necessity instead of spending bitter years arguing futilely about the necessity of virtue. If concession agreements moved away from equity ownership or included the option of systematic divestment and if procedures were adopted for regular renegotiation of terms, United States diplomacy would probably find itself less frequently locked into the defense of a business contract that a middle-management team from a big corporation negotiated from a position of strength years in the past.[23]

United States foreign policy is critically described as overly legalistic, bureaucratically determined and unresponsive to the wishes of top policy-makers. It is a mystery to many public policy analysts why the United States regularly produces policy outcomes, especially at the intermediate level just below the "high politics" of the White House, State, Defense and Treasury, that put the country in the apparent position of the inflexible, dogmatic, unrealistic exploiter, despite the "better judgment" of the policy formulators.

This study of the balance of power between American investors and host countries may provide both an explanation and a cure. It shows that the evolution of concession contracts is likely to present United States policy makers with recurring crises of a kind with which they are particularly ill-equipped to deal imaginatively. They are presented with presently broken contracts that have been solemnly signed by host country governments in a moment of weakness years in the past, with disputes that frequently have escalated to the stage of nationalization or expropriation, and with pleas by businesses that have probably been the least agile and most inflexible in the industry in the past and that are now weak and have nowhere else to turn. Corporations did not invite policy makers to pass judgment on whether they were making too

23. *See, e.g., Hearings on S. 126 Before the Subcomm. on Western Hemisphere Affairs of the Senate Comm. on Foreign Relations,* 91st Cong., 1st Sess. (1969) (testimony of R. Goodwin and L. Einaudi); Goodwin, *Letter from Peru,* THE NEW YORKER, May 17, 1969, at 64. *See also* R. BLOOMFIELD, WHO MAKES AMERICAN FOREIGN POLICY? SOME LATIN AMERICAN CASE STUDIES (Harvard Center for Int'l Affairs, Mar., 1972); J. LEVINSON & J. DE ONIS, THE ALLIANCE THAT LOST ITS WAY: A CRITICAL REPORT ON THE ALLIANCE FOR PROGRESS (1970); Mitchell, *Domination and Incoherence in U.S. Latin American Policy,* in POLITICAL RELATIONS BETWEEN THE UNITED STATES AND LATIN AMERICA (R. Fagen & J. Cotler eds. 1974).

much profit in the past, but they put policy makers under pressure to affirm that the company is being forced to accept too little profit or compensation now. If middle-level policy makers side with the corporations in these "routine" crises, they face the outrage of the host countries; if they side with the countries, they face the outrage of the corporations and their allies in the Congress.[24] Policy makers are faced with the choice of adopting a legalistic solution, or else of trying to work out a compromise at a point chosen by the companies and under the worst possible conditions.

It is a messy undertaking that they are not prepared to handle well. A realistic appraisal of our capacity to effect change in a positive way would suggest that it is an undertaking that they should not be handling at all.

24. This is true regardless whether the investment—or the debt—has been formally guaranteed by the Overseas Private Investment Corporation.