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Christiana Ochoa
Indiana University Maurer School of Law, cochoa@indiana.edu

Patrick Keenan
University of Illinois College of Law

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THE HUMAN RIGHTS POTENTIAL OF SOVEREIGN WEALTH FUNDS

Patrick J. Keenan* & Christiana Ochoa**

When World Bank president Robert Zoellick called for sovereign wealth funds to invest one percent of their capital in Africa,[1] he was expressing what has become the conventional wisdom in two distinct ways. First, many scholars and policymakers have come to believe that poor countries are better served by private investment than traditional public development assistance.[2] For example, in 2006 private capital displaced official development assistance as the dominant source of finance for African states, and all indications demonstrate that states are unlikely to significantly increase official development assistance in the near future.[3] Indeed, Zoellick's suggestion echoed a similar call

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* Associate Professor of Law & Corman Faculty Scholar, University of Illinois College of Law.

** Associate Professor of Law, Indiana University Maurer School of Law—Bloomington.
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1. Robert Zoellick, President, World Bank Group, A Challenge of Economic Statecraft, Address at the Center for Global Development (Apr. 2, 2008), *available at* http://go.worldbank.org/KRFPZ4OU30.

2. *See* Chris Bryant, *IFC Looks to Wealth Funds for African Assistance*, Fin. Times, Apr. 14, 2008, at 8 ("Private capital flows in 2006 overtook official aid as the main source of external finance for sub-Saharan African countries, quadrupling to $48bn between 2000 and 2006, compared with $40bn in official aid flows.").

3. While aid, especially for uses other than debt relief is increasing slightly, and increasing at a slightly higher rate for sub-Saharan African countries than for others, many countries have decreased their development assistance in recent years and the OECD has expressed concern that donor countries are not planning to fulfill their development aid commitments. *See, e.g.*, Eckhard Deutscher, Chairman, Org. for Econ. Co-operation & Dev. [OECD], Dev. Assistance Comm., Remarks at a Press Conference (Apr. 4, 2008), *available at* http://www.oecd.org/document/37/0,3343,en_2649_33721_40385189_1_1_1_1,00.html (indicating that aid to sub-Saharan Africa is increasing at a faster rate than aid to other places); Statistics and Monitoring Division, OECD Development Co-operation Directorate, Debt Relief is Down: Other ODA Rises Slightly (2008), *available at* http://www.oecd.org/dataoecd/27/55/40381862.pdf (indicating that a number of states have decreased their total development assistance and that non-debt relief increased slightly); Angel Gurría, Secretary-General, OECD, 'We Must Do Better:' Trends in Development Assistance, Remarks (Apr. 4, 2008), *available at* http://www.oecd.org/document/7/0,3343,en_2649_34487_40385351_1_1_1_1,00.html (imploring countries to redouble their aid donations).

from the Organization for Economic Cooperation and Development.[4]

The second way that Zoellick's call reflected the conventional wisdom is the implicit assumption that a large infusion of wealth would benefit the people of Africa. If wealthy countries were to heed Zoellick's call, there would be an influx of up to $30 billion in new equity investment in Africa.[5] At first blush, this might appear to be a pure benefit likely to lead to economic growth and improvement in the welfare of people located in the world's poorest countries. But history has shown that infusions of wealth from wealthy countries to developing countries have not had their intended effect. For example, states that receive substantial revenue from the sale of natural resources like oil, gas, or minerals have often fared worse than similar states without such resources.[6] In many countries, development assistance has had very little impact on economic growth and many of the biggest recipients of foreign aid are less well off now than they were two generations ago.[7] There are compelling reasons to be skeptical over whether increased investment in Africa by sovereign funds promoted by Zoellick, even if heeded, will do much good, and some reasons to think that such investment might actually do harm.

In this Article we propose a mechanism designed to increase the likelihood that greater sovereign investment in Africa will actually benefit the citizens of recipient states. We take as our starting point an important facet of Zoellick's proposal. He suggested that one-percent of investments from sovereign wealth funds be channeled through the International Finance Corporation,[8] the branch of the World Bank responsible for private sector investment in the service of the World Bank's mission of reducing poverty.[9] Zoellick argued that the IFC's "access, knowledge, and capital" could "help other investors over the

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4. *See* JAVIER SANTISO, BANKING ON DEVELOPMENT: PRIVATE FINANCIAL ACTORS AND DONORS IN DEVELOPING COUNTRIES (2008), *available at* http://www.oecd.org/dataoecd/16/4/40265826.pdf.

5. *See* Steven R. Weisman, *World Bank Calls on Sovereign Funds to Invest in Africa*, N.Y. TIMES, Apr. 3, 2008, at A8.

6. *See generally* Michael L. Ross, *The Political Economy of the Resource Curse*, 51 WORLD POL. 297 (1999).

7. *See generally* WORLD BANK, ASSESSING AID: WHAT WORKS, WHAT DOESN'T, AND WHY (1998).

8. *See* Zoellick, *supra* note 1.

9. The World Bank Group comprises the International Finance Corporation, the International Bank for Reconstruction and Development, the International Development Association, the Multilateral Investment Guarantee Agency, and the International Center for the Settlement of Investment Disputes. All five entities share a mission of reducing poverty, but they address different development challenges. *See generally* www.worldbankgroup.org.

initial hurdles of investing in new equity opportunities in Africa."[10] Toward this end the IFC announced in December 2008 that it would create a "Sovereign Funds Initiative" to enable the IFC "to raise and manage commercial capital from sovereign funds for equity investments in some of the poorest developing countries."[11] The IFC has not yet released details about the new initiative, but it is at least an indication that the IFC is attempting to put Zoellick's words into action. The IFC has an extensive record of investing in Africa and providing advisory services for private investors,[12] which suggests that the IFC could add value to the investments of others by, for example, helping to identify viable projects or avoid untrustworthy partners. But the real potential of the Sovereign Funds Initiative to do good (or harm) depends in part on how it shapes the incentives and constraints facing the recipients of its investments.

Zoellick's proposal and the nascent Sovereign Funds Initiative have the potential to provide real benefits to poor people in Africa if structured appropriately, but must first resolve an important and difficult problem: additional wealth can reduce welfare. To describe this problem we use the term unconditioned wealth, by which we mean wealth owned or obtained by states unaccompanied by strong political or market conditions.[13] Examples include the massive influx of investments from China into Africa, typically free of social or political conditions, windfall revenues from the sale of natural resources, and development assistance delivered without meaningful oversight or attention to the uses its recipients make of it.[14] Without such conditions, wealth—whether in the form of revenue from the sale of natural resources, development assistance, or sovereign wealth funds—can be used in ways that either do not meaningfully contribute to economic

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10. Zoellick, *supra* note 1.

11. Press Release, Int'l Fin. Corp. [IFC], IFC Board Approves Initiatives for Financial Crisis Response and Sovereign Funds to Support Private Sector in Emerging Markets (Dec. 18, 2008), *available at* http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument &UNID=E915A6E933FD599E85257523007974CD.

12. *See generally* IFC, IFC ANNUAL REPORT 2007: SUB-SAHARAN AFRICA, *available at* http://www.ifc.org/ifcext/annualreport.nsf/AttachmentsByTitle/AR2007_v1_Regions/$FILE/AR2007_Regions.pdf (describing the IFC's work in Africa).

13. For the complete version of this argument, *see* Patrick J. Keenan, *Curse or Cure? China, Africa, and The Effects of Unconditioned Wealth*, 27 BERKELEY J. INT'L L. 83 (2009). In this Article, we sketch out the broad outlines of this argument in Part I.A, *infra*.

14. As we explain in Part III.A, *infra*, when we discuss "conditions," we are not advocating a return to the IMF's policy of conditionality or anything similar. Instead, we use the term to describe the various incentives and conditions associated with all wealth.

development or that actually reduce social welfare.[15]

In this Article, we propose that the World Bank transforms its Sovereign Funds Initiative into what we will call the "Multilateral Sovereign Investment Agency" (MSIA). The MSIA would be an investment vehicle through which sovereign funds would channel at least a portion of their assets under management. The management would then use these funds to make equity investments in enterprises in Africa. Our objective in proposing the MSIA is to learn from history. African states have received influxes of wealth many times before, but this wealth has not produced meaningful economic development or improved the lives of ordinary people. If the World Bank's new program is structured in a way that reflects the best available understanding of why previous influxes of wealth have done so little good, it has the potential to be a meaningful development tool and not just another abortive attempt to increase the amount of wealth flowing into Africa without considering the effects of that wealth on the welfare of people living in recipient states.

In Part I of this Article we situate our proposal in a broader theoretical framework. We show that infusions of wealth have not significantly contributed to economic development. To do this we rely on recent econometric studies of the efficacy of development assistance and the history of resource-dependent economies to show that transfers of wealth, standing alone, have not sparked economic development or enhanced welfare. After surveying the evidence, we show *why* wealth transfers have been ineffective: those transfers have not generated the incentives necessary to ensure that newly-attained wealth is used to benefit ordinary citizens rather than support the regime that happens to be in power. Resource wealth, development assistance, and, increasingly, investments from sovereign funds can all suffer from this malady. Wealth, regardless of the source, is unlikely to benefit citizens unless someone has the capacity to hold the managers of the wealth accountable if they waste or steal it. This accountability can come from an engaged citizenry that votes out of office politicians who mismanage the economy, or from financial markets that reward well-managed firms and punish those who are poor stewards of shareholder investment. Although this is not a new problem, the conventional approaches to managing it are inadequate because they assume a model of state decision-making that is inconsistent with the capacity, functionality, and will of many developing states. Many of the states most in

15. *See* Keenan, *supra* note 13, at 103-09.

need of development assistance or foreign investment simply do not adequately fulfill their legal duty to protect human rights, are led by unaccountable rulers, and have economies in which transparency is rare and corruption is common.[16] To fill this gap, we argue that, especially in the case of fragile or dysfunctional states, the protections to which citizens are entitled can be provided through transnational mechanisms designed to mitigate the problems associated with investment in these locations. Our proposed MSIA is an attempt to fashion a real-world solution, based on the best available research on wealth and developing states, to the problems that can come from investment in places where regimes use wealth to protect themselves, not enhance the lives of their citizens.

In Part II we describe our proposal in more detail. We argue that the MSIA could be created within the existing framework of the World Bank Group and sketch the broad outlines of MSIA. We deliberately do not attempt to specify every detail of the proposed new entity. Such operational details are certainly important, but must flow from the institution's theoretical framework rather than precede it. Many of our institutional design principles are drawn from the venture capital literature. Venture capital firms receive funds from outside investors and then invest those funds in very early stage businesses.[17] The venture capital market has evolved in such a way as to efficiently link capital with promising entrepreneurs.[18] We draw on this literature to better understand three main issues: the importance of actively seeking investment opportunities rather than passively awaiting applications, the need for investors to provide management assistance in addition to financial capital, and the potential for investors to help encourage ethical practices and compliance with the law. The venture capital model is useful primarily because it demonstrates how institutional design features can manage the incentives and interests of outside

16. *See generally* WORLD BANK, DOING BUSINESS 2009, *available at* http://www.doingbusiness.org/Documents/FullReport/2009/DB_2009_English.pdf; Transparency International, *Promoting Good Governance in Africa*, http://www.transparency.org/news_room/in_focus/2009/promoting_good_governance_in_africa; JOHN RUGGIE, REPORT OF THE SPECIAL REPRESENTATIVE OF THE SECRETARY-GENERAL ON THE ISSUE OF HUMAN RIGHTS AND TRANSNATIONAL CORPORATIONS AND OTHER BUSINESS ENTERPRISES (2008), *available at* http://www.reports-and-materials.org/Ruggie-report-7-Apr-2008.pdf.

17. *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070-71 (2003) (describing the typical structure of the venture capital market).

18. *See* Robert D. Cooter, *Innovation, Information, and the Poverty of Nations*, 33 FLA. ST. U. L. REV. 373, 375-77 (2005) (describing the process and importance of connecting innovation and capital).

investors, fund managers, and portfolio companies in a way that can produce wealth for all.

In Part III we consider ways to implement our proposal and anticipate several possible complications or objections. Although there are many possible objections, we focus on three: that our proposal amounts to a return to ineffective and offensive conditionality; that our proposal does not account for the history of exploitation and abuse associated with corporate activity in Africa; and that our proposal is simply implausible.

Separate and apart from the roadmap provided above, a couple of brief clarifications and a statement of our normative premises are in order before moving on. First, sovereign funds[19] are asset management vehicles that invest public funds. In contrast to currency reserves, which are typically managed by central banks with the objective of ensuring liquidity and the stability of the country's currency, sovereign funds are investment vehicles that permit states to seek higher returns by taking on higher risks. Although their rules vary widely, sovereign funds can invest in securities, property, commodities, and private equity. Sovereign funds are funded by a variety of sources, including fiscal surpluses, foreign reserves, and revenue from the sale of commodities such as oil or natural gas. Although it is impossible to be certain because sovereign funds are largely unregulated, most observers estimate that sovereign funds manage between $2 and $3 trillion in assets.[20]

There are two normative propositions on which our proposal is premised that we make explicit here. The first is that the objective of both development assistance and private investment should be to enhance the welfare of ordinary people. This is not to suggest that the motivations for charity and investment are or ought to be identical. Instead, we maintain that charity and private investment should aim to benefit citizens, not the regime that happens to be in power. Just as development assistance is designed to benefit citizens, so too should

19. We use the terms "sovereign funds" instead of the more conventional "sovereign wealth funds" to parallel the language used by the World Bank in its policy statement regarding the Sovereign Funds Initiative.

20. *See* INT'L MONETARY FUND [IMF], SOVEREIGN WEALTH FUNDS—A WORK AGENDA 7 (2008), *available at* http://www.imf.org/external/np/pp/eng/2008/022908.pdf (estimating that sovereign funds manage assets worth between $2.093 trillion and $2.968 trillion). It is, of course, likely that sovereign funds have suffered along with all other investors in the current economic crisis. For an analysis of the likely effect of the crisis on some sovereign funds, *see* Brad Setser & Rachel Ziemba, *GCC Sovereign Funds: Reversal of Fortune* (Council on Foreign Relations, Working Paper, 2009) (estimating that the value of sovereign funds controlled by Persian Gulf states fell "from almost $1.3 trillion in 2007 to $1.2 trillion in 2008").

the sale of oil or the creation of an export processing zone, for example, benefit the people in whose names the action is taken. The second normative proposition is that the state duty to protect citizens from human rights violations can be shared.[21] That is, when an individual state is incapable of protecting its citizens, other states (such as those states benefiting from trade with dysfunctional states) or groupings of states acting through international institutions should fulfill the duty to protect. Because this second proposition is perhaps the more controversial, we devote the rest of this Part to showing why it is appropriate.

The emergence of the international human rights regime has shifted previous fundamental understandings regarding state sovereignty. Sovereignty is itself now conditioned on a state's ability and will to protect the human rights of its citizens.[22] The human rights regime seeks to protect individuals from violations of their rights, regardless of whether those rights have been violated by agents of the state or by private actors.[23] When a state fails to protect its citizens from violations of human rights and fails to sanction violations, the state itself has been held to have breached its duty to protect human rights.[24]

Not all states have the capacity or the will to protect human rights and may make very little real effort to fulfill this duty. This is particularly evident in failed and failing states, but it is also an all too common phenomenon in states engaged in long-running conflicts, in states that have authoritarian governments, and in states that have too few resources to give full effect to their efforts to protect human rights. In all of these cases, the ultimate subjects of the human rights regime suffer as a result of the state's failings.

When a state is unable or unwilling to fulfill its duty to protect human rights, the result should not be that the citizens of that states simply must suffer their bad fortune of having been born in the wrong place. In these cases, the international community—other states and international institutions—have often shared in fulfilling the duty to protect human rights. The United Nations human rights system, the regional human rights bodies and relatively new creations such as the International Criminal Court (ICC), the International Criminal Tribunal for the former Yugoslavia (ICTY), and the International Criminal Tribunal

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21. *See* RUGGIE, *supra* note 16.

22. *See* Vesselin Popovski, *Essay: Sovereignty as a Duty to Protect Human Rights*, UN CHRONICLE ONLINE EDITION (2004), http://www.un.org/Pubs/chronicle/2004/issue4/0404p16.html.

23. THE INTERNATIONAL COUNCIL ON HUMAN RIGHTS POLICY, BEYOND VOLUNTARISM: HUMAN RIGHTS AND THE DEVELOPING LEGAL OBLIGATIONS OF COMPANIES 46 (2002).

24. *Id.*

for Rwanda (ICTR) present examples of the international community recognizing that protecting a particular state's citizens often requires concerted action by entities outside of that state.

There has been less recognition of this duty to share in the protection of human rights in the areas of business and finance. The recent Report of the Special Representative to the Secretary General on the issue of business and human rights, for example, takes a fairly traditional position, asserting only that it is a state's duty to protect human rights.[25] A strong reliance on the state's duties will not function effectively in the context of a recalcitrant state. In these situations, states, private actors, and international institutions should share the duty to protect those rights that are violated in connection with business and financial activity.

However, merely asserting a shared duty to protect is not enough. Instead, we propose concrete measures for knowing when other states, private actors, and international institutions will bear such duties. We propose a fairly bright line: when states and investors knowingly engage with host states that are unable to protect their own citizens against harms that may be committed or facilitated by the investment, they undertake to share this duty with the host state.[26] In short, arrangements that result in investors benefiting from the dysfunctional nature of host states should give rise to the investor's obligation to share in the duty to protect human rights.

Similarly, when international organizations provide countries with development aid, loans, or other grants, they also join in the duty to protect, especially to the extent that their own activities may negatively affect growth in their target-country. It is unacceptable that international organizational involvement can lead to negative growth. The best available evidence demonstrates this effect and suggests the development of policies that mitigate harm associated with involvement of international organizations.

25. *See* RUGGIE, *supra* note 16, at 9-20.

26. There are a number of indicators now available for determining whether a particular host-state suffers from the failures that would give rise to sharing the duty to protect. *See, e.g.*, FAFO INSTITUTE, RED FLAGS: LIABILITY RISKS FOR COMPANIES OPERATING IN HIGH-RISK ZONES, *available at* http://www.redflags.info/index.php?page_id=14&style_id=0; OECD, PRINCIPLES FOR GOOD INTERNATIONAL ENGAGEMENT IN FRAGILE STATES AND SITUATIONS (2007), *available at* http://www.oecd.org/dataoecd/61/45/38368714.pdf.

I. The Problem: Managing the Frontier of Economic Development, Governance, and Finance

If wealthy countries actually follow Zoellick's call, $30 billion in new equity investments would not be the first influx of wealth into African states. For example, the sale of oil or other natural resources in the past five years has generated enormous revenue for a number of African states. Furthermore, many African states have long received substantial official development assistance and country-to-country loans. Unfortunately, the available evidence shows that the infusion of wealth has had relatively little effect on the welfare of ordinary people. Because we conceive of the MSIA as an attempt to address these specific problems, we first describe them with some particularity, including an analysis of their causes and consequences. Then, in Part II, we argue that the World Bank must structure its proposed initiative so as to mitigate or eliminate the problems we have identified. The rapid ascendance of sovereign funds suggests to us, as it has to the World Bank, their great potential to contribute possibly useful resources to very poor countries. But this potential will only be realized if the wealth they contribute includes coordinated, state-of-the-art good practices tailored to the observed behaviors of typical recipient states. The novelty of sovereign funds and the proposed MSIA also opens the possibility of incorporating innovative investment channels coupled with constraints and incentives, including explicit transparency requirements,[27] anti-corruption regulations and monitoring,[28] and measures that incorporate the latest research regarding the human rights duties and responsibilities of states and private actors.[29]

The observation that more wealth can reduce welfare has vexed scholars and policymakers alike. States with abundant natural resources often develop much more slowly than do states with less abundant resources.[30] Conventional economic theory suggests that

27. *See, e.g.*, Karin Alexander & Stefan Gilbert, Oil and Governance Report: A Case Study of Chad, Angola, Gabon, and Sao Tome e Principe (2008), *available at* http://www.eitransparency.org/files/publication_file/Oil_and_Governance_Report_March_2008.pdf.

28. One example of this is the adoption of legislation similar to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. To date, only thirty-seven countries are signatories to this Convention. *See* OECD, OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Ratification Status as of March 12, 2008 (2008), *available at* http://www.oecd.org/dataoecd/59/13/40272933.pdf.

29. *See* Ruggie, *supra* note 16.

30. *See, e.g.*, Jeffrey D. Sachs & Andrew M. Warner, *Natural Resource Abundance and Economic Growth* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 5398, 1995) ("The oddity of

resource-rich countries should benefit from an abundance of natural resources, particularly resources such as oil or natural gas that are consistently in great demand. Although there are exceptions, resources have not proven to be a boon to resource-rich countries. Indeed, when compared with other developing countries, those with resource-dependent economies underperform.[31] It is not only revenue from the sale of natural resources that can have unexpectedly negative effects. For many poor countries, official development assistance appears to do much less good than expected, and can even reduce social welfare.[32] In previous writings, we have referred to such wealth transfers as "unconditioned wealth,"[33] and argued that transfers of wealth without appropriate incentives and constraints to ensure that the wealth is used in socially productive ways are unlikely to lead to sustained improvements in the lives of ordinary people, regardless of whether the wealth arrives in the form of resource revenue, development assistance, or quasi-private investment.[34] Put slightly differently, what matters for development is not the nominal form of or justification for the wealth transfer but the conditions associated with it. Without the discipline imposed by an engaged and informed polity, the market, or other states, it is too easy for recipient regimes to use wealth transfers to solidify their hold on power at the expense of broad-based development.

A. *Identifying the Constraints and Incentives that Matter Most*

Why have infusions of wealth been so unhelpful to poor countries? We argue that when wealth flows from one state to another or from institutions to states, whether that wealth has a positive or negative effect on citizens in the recipient state depends on the conditions associated with the wealth. What we call unconditioned wealth refers to transfers of funds or goods without accompanying conditions that would otherwise create incentives for the recipient to use the wealth in

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resource-poor economies outperforming resource-rich economies has been a recurring motif of economic history.").

31. *See generally* Ross, *supra* note 6 (summarizing the positive case demonstrating the existence of the resource curse and analyzing possible causes).

32. *See generally* Simeon Djankov et al., *The Curse of Aid*, 13 J. ECON. GROWTH 169 (2008) (surveying literature on the relationship between development assistance and institutional quality, official corruption, economic growth, and other factors, and finding that dependence on aid is negatively associated with institutions and governance).

33. *See* Keenan, *supra* note 13.

34. This argument is developed more fully in Christiana Ochoa, *From Odious Debt to Odious Finance: Avoiding the Externalities of a Functional Odious Debt Doctrine*, 14 HARV. INT'L L.J. 109 (2008).

socially-beneficial ways.[35] To be sure, previous transfers of wealth, including conventional development assistance in the form of grants or loans made at concessional rates, foreign direct investment in private enterprises, or quasi-public joint ventures, come with conditions attached. Many of the conditions are outcome-oriented, seeking goals such as economic liberalization, democratization, predictability, regulation, deregulation, or general improvement in social welfare. Some of these goals have been lauded, while others have been widely discredited; the history of such conditions, discussed briefly below, is decidedly mixed.[36]

Our approach is different. We do not focus solely, or even primarily, on conditions of this sort. Instead, we define conditions as the amalgam of constraints and incentives associated with the wealth transfer, regardless of whether those constraints or incentives are formally denominated as such or merely the consequence of an infusion of wealth into a particular set of political, social, and economic institutions. More importantly, our approach is different because the recipients of the wealth transfer and associated conditions will be private entrepreneurs—not states.

1. The Descriptive Case: The Puzzling Ineffectiveness of Wealth Transfers

It is by now commonplace to observe that economies heavily dependent on resource wealth often do not advance as well as those without similar resources. In one of the most influential studies in development economics, Jeffrey D. Sachs and Andrew M. Warner analyzed the role of natural resource wealth in economic development for a sample of 97 resource-rich economies.[37] Sachs and Warner compared each country's growth rate to its level of resource dependence, as indicated by the ratio of resource-based exports to gross domestic product.[38] Even after controlling for a number of other variables, Sachs and Warner found "a statistically significant, inverse, and robust association between natural resource intensity and growth."[39] The work of Sachs and Warner,

35. *See generally* Keenan, *supra* note 13.

36. *See* IMF, CONDITIONALITY FACTSHEET (May 2008), http://www.imf.org/external/np/exr/facts/conditio.htm.

37. *See* Sachs & Warner, *supra* note 30, at 2, 49 fig.1 (noting a sample size of 97 developing countries).

38. *Id.* at 2 (comparing "each country's annual growth rate between 1970-89 in relation to the country's natural resource-based exports in 1970, measured as a percent of GDP").

39. *Id.* at 21.

among others, has created a burgeoning subfield of development economics devoted to documenting and analyzing this basic problem.[40]

Now commonly called the "resource curse,"[41] this phenomenon was initially seen as a version of the "Dutch disease,"[42] a term used to describe the macroeconomic effects on a domestic economy resulting from the sale of natural resources.[43] It turns out that the effects of the resource curse are broader than simple currency value distortions or other narrow macroeconomic results. These may include an increase in official corruption,[44] greater likelihood of conflict,[45] misallocation of resources,[46] longer tenure for leaders of the ruling regime,[47] and

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40. A full survey of this vast literature is far beyond the scope of this Article. For thorough surveys of the economic and political economic literature, *see* Ross, *supra* note 6 (reviewing literature documenting and explaining the negative effect of natural resource wealth on economic growth); Andrew Rosser, *The Political Economy of the Resource Curse: A Literature Survey* 13 (Inst. Dev. Studies, Working Paper No. 268, 2006) (finding, after an extensive literature survey, that "while there is strong evidence to support the notion of a resource curse, it is by no means conclusive"). *But see* Michael Alexeev, *The Curse of Aid*, REV. OF ECON. AND STAT. (forthcoming 2010) (arguing that much of the literature on the resource curse reaches its conclusions on the basis of bad models).

41. It appears that economist Richard M. Auty coined this phrase in his book SUSTAINING DEVELOPMENT IN MINERAL ECONOMIES: THE RESOURCE CURSE THESIS (1993). Auty sought to explain why countries heavily dependent on the sale of certain minerals "have performed less well than the developing countries as a whole." *Id.* at 6. Although Auty's focus was on "hard mineral exporters" as opposed to "hydrocarbon producers," *id.* at 3, the phrase "resource curse" has since come to include economies dependent on oil as well as other extractable resources. *See* Ross, *supra* note 6, at 298 (analyzing the ways that "minimally processed natural resources, including hard rock minerals, petroleum, timber, and agricultural commodities, influence[] economic growth").

42. This phrase originated in a 1997 article in the *Economist* contrasting the "external health and internal ailments" of Holland's economy. *The Dutch Disease*, ECONOMIST, Nov. 26, 1977, at 82.

43. *See* PAUL COLLIER, THE BOTTOM BILLION: WHY THE POOREST COUNTRIES ARE FAILING AND WHAT CAN BE DONE ABOUT IT 39-40 (2007) (describing the causes and consequences of the Dutch disease).

44. Aaron Tornell & Phillip R. Lane, *The Voracity Effect*, 89 AM. ECON. REV. 22, 23 (1999). Tornell and Lane argue that where political and legal institutions are weak, unconditioned wealth can produce "a more-than-proportional increase in redistribution" of wealth from resource rents. *Id.* at 42.

45. *See generally* Silje Aslaksen & Ragnar Torvik, *A Theory of Civil Conflict and Democracy in Rentier States*, 108 SCANDINAVIAN J. ECON. 571, 584 (2006) (presenting empirical results showing that greater "resource wealth increases the expected payoff from both elections and conflict").

46. *See, e.g.*, James A. Robinson & Ragnar Torvik, *White Elephants*, 89 J. PUB. ECON. 197, 198 (2005) (describing decisions by the government of Zambia to place manufacturing plants in locations that would ensure support from voters even though the locations were not served by reliable transportation networks and alternative locations were available).

47. *See* Benjamin Smith, *Oil Wealth and Regime Survival in the Developing World, 1960-1999*, 48 AM. J. POL. SCI. 232, 238 (2004) (finding that "[o]il dependence is a positive predictor of durability, but at the same time is negatively related to democracy, another positive predictor").

reductions in various measures of social welfare.

Next, consider development assistance, which has also been much less beneficial than might be expected, given the magnitude of the assistance. The nominal objective of official development assistance is to enhance social welfare in the recipient state. The metric by which this goal has typically been measured is whether the assistance contributed to economic growth; by this measure development assistance does not fare well. Even among economists who agree on little else, there is broad agreement that development assistance has not produced positive results in most instances. For example, William Easterly, a prominent skeptic of development assistance, has questioned whether there has been any positive effect from aid as it has typically been conveyed.[48] On this point—and perhaps only on this point—Easterly agrees with David Dollar, who is much less skeptical of foreign assistance in general, but who also notes that aid has had very little positive effect in recipient countries.[49] The problem is not merely that development assistance has not been as effective as intended. Just as with resource revenue, aid also appears to contribute to a reduction in social welfare and an erosion of good governance.[50] For example, foreign aid appears to cause an increase in official corruption as politicians compete for the control of the wealth.[51] Aid dependence can also undermine the quality of a country's institutions of governance and erode democracy.[52] To be sure, there are examples of development projects that have worked. Nonetheless, over the long-term, foreign aid has not contributed to growth.[53]

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48. *See* William Easterly et al., *Aid, Policies, and Growth: Comment*, 94 AM. ECON. REV. 774, 779 (2004) (finding data questioning whether development assistance has had any positive effects on growth in recipient countries).

49. *See, e.g.*, Craig Burnside & David Dollar, *Aid, Policies and Growth*, 90 AM. ECON. REV. 847, 848 (2000) (arguing that "on average aid has had little impact on growth, although a robust finding was that aid has had a more positive impact on growth in good policy environments").

50. *See, e.g.*, Stephen Knack, *Aid Dependence and the Quality of Governance: Cross-Country Empirical Tests*, 68 S. ECON. J. 310, 310 (2001) (presenting data showing that "higher aid levels erode the quality of governance, as measured by indices of bureaucratic quality, corruption, and the rule of law").

51. *See, e.g.*, Alberto Alesina & Beatrice Weder, *Do Corrupt Governments Receive Less Foreign Aid?*, 92 AM. ECON. REV. 1126, 1127 (2002) (finding that "an increase in aid increases corruption").

52. *See* Simeon Djankov et al., *The Curse of Aid*, 13 J. ECON. GROWTH 169, 170 (2008) (finding that if "a country receives the average amount of aid over GDP over the whole period, then the recipient country would have gone from the average level of democracy in recipient countries in the initial year to a total absence of democratic institutions").

53. *See, e.g.*, Michael Clemens et al., *Counting Chickens When They Hatch: The Short Term Effect of Aid on Growth,* 3, (Ctr. for Global Dev., Working Paper No. 40, 2004) (finding, after categorizing

Just as resource revenue and development assistance do not necessarily translate into economic development enjoyed by the populace, private investment, like development assistance, does not necessarily contribute to the economic development of poor countries. For decades, researchers have demonstrated that foreign investment can act as a net drain on the wealth of developing countries.[54] Contrary to the widely-held belief that FDI contributes to economic development, empirical evidence demonstrating that FDI often slows growth contradicts this common justification for FDI.[55] This is particularly true in poor countries[56] where a minimum level of social capacity is required for FDI to promote economic growth.[57] In particular, private investment can diminish monetary gains in countries that rely heavily on the extraction of natural resources and can degrade their long-term potential (in the form of retained natural-resources) for economic development.[58]

Investor-state arrangements often contemplate that the investor will remit funds to the state via taxes, fees, and profit-sharing payments. However, firms regularly negotiate for long-term tax holidays, diminish their obligations to pay fees, and share profits through complex transfer-pricing arrangements. Such arrangements enable firms to significantly demonstrate that a host-state-based subsidiary has earned low profits (or even suffered losses) within the host-country while the home-state-based firm shows significant profits arising from up-stream re-pricing of the goods derived from the host-country.[59] This pricing architecture leaves investor host-states with significantly less economic

development assistance endeavors by where the aid was targeted and how it was used—emergency aid, long-term aid, and short-term aid—that short-term aid is correlated with economic growth).

54. *See, e.g.*, Peter Evans, *National Autonomy and Economic Development: Critical Perspectives on Multinational Corporations in Poor Countries*, 25 INT'L ORG. 675, 678-80 (1971) (citing early studies demonstrating countries such as India, Indonesia, and many in Latin America exported more funds than they received of their surplus wealth during the nineteenth century).

55. *See* Stephen Kosack & Jennifer Tobin, *Funding Self-Sustaining Development: The Role of Aid, FDI and Government in Economic Success,* 60 INT'L ORG. 205 (2006).

56. *Id.*

57. Marta Bengoa & Blanca Sanchez-Robles, *Foreign Direct Investment, Economic Freedom and Growth: New Evidence from Latin America,* 19 EUR. J. POL. ECON. 529 (2003) (demonstrating that variables related to social capacity, including the size of the host-country economy, its economic climate, political stability, and public infrastructure, lead to a lack of social capacity in many poor countries).

58. This argument is developed more fully in Christiana Ochoa, *supra* note 34.

59. *See, e.g.*, GREENPEACE, CONNING THE CONGO: LOGGING SECTOR REVIEW (2008), *available at* http://www.greenpeace.org/raw/content/international/press/reports/conning-the-congo.pdf; GLOBAL WITNESS, HEAVY MITTAL? A STATE WITHIN A STATE: THE INEQUITABLE MINERAL DEVELOPMENT

growth than they might otherwise enjoy. FDI proponents may argue that intangible values, such as technology and "know-how" are transferred via FDI. Even accounting for this value, FDI is not beneficial to poor countries with low levels of social capacity.[60]

2. Some Causes and Consequences of Ineffective Wealth Transfers

The observation that unconditioned wealth has been ineffective or counterproductive in many developing countries is an important initial step in the analysis, but a determination of how and why unconditioned wealth comes to be wasted or even causes harm is even more important. Any policy designed to mitigate the harms from unconditioned wealth must target the causal pathways through which such wealth works its mischief. In this Part, we identify three possible causal mechanisms and present the evidence supporting each hypothesis.[61] We argue that unconditioned wealth can cause behavioral, political, and institutional distortions that can eliminate the beneficial effects of wealth and even transform it into a source of harm. Our objective is to identify possible points of intervention—spaces in the complicated intersection of resources, institutions, individual behavior, financial markets, and the like in which changes in policy might be most effective.

a. *Behavioral Distortions: Rent-seeking*

One explanation for the problems caused by unconditioned wealth

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AGREEMENT BETWEEN THE GOVERNMENT OF LIBERIA AND MITTAL STEEL HOLDINGS NV (2006), *available at* http://www.globalwitness.org/media_library_detail.php/156/en/heavy_mittal.

60. Bengoa & Sanchez-Robles, *supra* note 57, at 532.

61. There is a fourth potential causal mechanism that we do not consider in any detail. Many economists have attributed the harms caused by unconditioned wealth to the Dutch Disease. On this account, an increase in the price of a principal export—such as natural resource revenue—causes real wages to increase and the real exchange rate to rise. These two effects combine to reduce the competitiveness of those sectors of the economy not involved in the production or sale of the resource. *See generally* COLLIER, *supra* note 43, at 39-40 (explaining the dynamics of the Dutch Disease).

This account may well be true, but it ultimately begs the question of why countries continue to pursue such policies in the face of evidence that these policies are unlikely to enhance welfare for ordinary citizens or contribute to economic growth. We are, of course, not the first to notice this conundrum; indeed, much of the political economic research on wealth and development has been an attempt to explain it. *See, e.g.*, Paul Stevens & Evelyn Dietsche, *Resource Curse: An Analysis of Causes, Experiences and Possible Ways Forward*, 35 ENERGY POL'Y 56, 57 (2008) (arguing that in order to explain the resource curse as a result of the "continuous[] fail[ure]" of many countries to develop policies likely to avoid the Dutch Disease, economists and political scientists have "identif[ied] why countries would deliberately pursue poor policies").

is that when an individual perceives a short and sure way to become wealthy, they follow it to the exclusion of other options. As this occurs, the collective effect of their actions reduces the welfare in the country. Put another way, rent-seeking amounts to "[c]utting yourself a bigger slice of the cake rather than making the cake bigger."[62]

b. *Political Distortions: Rentier Effects*

When politicians in power can depend on revenue from the sale of a natural resource to fund their regime and the institutions of government, they are relieved of the need to make the politically difficult choices that might support broad-based economic development. For example, when a ruling regime can fund itself by selling natural resources, "the state has less need for taxation of the population, and without the pressure for taxation the state has less need to develop mechanisms of deep control of the citizenry."[63] In addition, a ruling regime can use unconditioned wealth to support politically-useful but economically-unsound investments.[64] In Nigeria, for example, to placate its supporters, the government has invested heavily in manufacturing. Unfortunately, those investments have contributed little to economic growth because the true objective of the government was political, not economic. According to one recent empirical study of Nigeria, "two-thirds of the investment in manufacturing by the government is consistently wasted."[65]

c. *Institutional Distortions*

When politicians manage assets with only political objectives in mind, they can make very bad investment decisions. In perhaps the most complete account of this phenomenon, Michael Ross has demonstrated how politicians in Indonesia, Malaysia, and the Philippines were motivated by the rents available from timber sales to undermine

62. MATTHEW BISHOP, ESSENTIAL ECONOMICS 225 (2004).

63. Jonathan Isham et al., *The Varieties of Resource Experience: Natural Resource Export Structures and the Political Economy of the Resource Curse*, 19 WORLD BANK ECON. REV. 141, 147 (2005).

64. *See, e.g.*, Ivar Kolstad et al., *Mission Improbable: Does Petroleum-Related Aid Address the Resource Curse?*, 37 ENERGY POL'Y 954, 955 (2009) (arguing that "increased natural resource rents offer governments both more opportunities and greater incentives to pay off political supporters to stay in power").

65. Xavier Sala-i-Martin & Arvind Subramanian, *Addressing the Natural Resource Curse: An Illustration from Nigeria* 13 (Nat'l Bureau Econ. Research, Working Paper No. 9804, 2003).

national and local institutions in order to exploit the timber.[66] Similarly, a recent report has illustrated this phenomenon among Cambodia's ruling elite.[67]

II. PROPOSAL: A MULTILATERAL SOVEREIGN INVESTMENT AGENCY

We propose the creation of a new entity within the existing World Bank Group, to be called the Multilateral Sovereign Investment Agency, which would receive investments from sovereign wealth funds and use those funds to invest in small- and medium-scale private enterprises in Africa. The principal objective of MSIA would be to facilitate investment by sovereign funds in those private sector investments most likely to alleviate poverty and contribute to economic growth in the poorest countries. It would attempt to accomplish this goal by identifying for-profit private sector investment opportunities in developing countries and taking equity stakes in those enterprises. In addition to managing investor funds, MSIA would serve as a source of information on investment opportunities in developing countries, encouraging compliance with socially-responsible investment principles, and supplying expertise to private enterprises seeking outside investors.

In broad terms, the proposed MSIA would exist as a fund to manage investments from sovereign funds seeking equity investments in private enterprises. In its operations, the MSIA would resemble a venture capital fund, which manages money from investors seeking potentially significant returns from equity stakes in start-up companies and willing to accept correspondingly higher levels of risk. Venture capital funds are a useful analogy because they often take direct equity stakes in enterprises as opposed to merely purchasing securities, bonds, or other market-traded assets, and they often have a greater degree of interaction with the target enterprise than would an ordinary investor, for example, one who purchased securities.[68]

A. *The Venture Capital Model*

Venture capital plays a vital role in the economies of developed countries, and an increasingly important role in developing countries. Indeed, Ronald Gilson, a leading American scholar of venture capital,

66. *See generally* MICHAEL L. ROSS, TIMBER BOOMS AND INSTITUTIONAL BREAKDOWN IN SOUTHEAST ASIA (2001).

67. GLOBAL WITNESS, COUNTRY FOR SALE (2009) (describing the kleptocratic management of Cambodia's public assets, including its natural resources).

68. Microenterprise also serves as a useful analogue and will be discussed below.

suggests that "creating a venture capital market has become the holy grail of economic development."[69] Our proposal is not an attempt to design a full-fledged venture capital market.[70] Instead, we draw on insights from the important role played by venture capital and venture capital firms in economic development and the advancement of social welfare as a way to identify the role the MSIA should play in Africa.

Venture capital is a form of financing used to support new or growing companies.[71] The use of venture capital is commonly associated with early-stage businesses "that have great financial needs and great risks involved, but . . . also have a high potential for growth and hence for potentially large profits."[72] Venture capital firms are enterprises that use funds received from outsiders to invest in entrepreneurial ventures.[73] The structure of an efficient venture capital market—the web of contracts connecting outside investors, fund managers, and entrepreneurs—is a vivid example of the importance of linking good ideas, capital, and skilled managers.

This market, with its many complexities, has inspired close attention from academics and policymakers alike, but we focus here on three principal features.[74] First, venture capital firms are important to economic development because they play an important sorting role by identifying innovative or promising ideas and supporting the best of those ideas. In this way, those innovations most likely to be socially useful have the opportunity to develop and reach a market. Second, venture capital firms typically work closely with the enterprises in which they invest and provide vital advice about management, marketing, financing, and the like. Many venture capital funds operate as quasi-

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69. Ronald J. Gilson, *supra* note 17, at 1068.

70. Scholars and policymakers have attempted to design venture capital markets (or theories to support a design). *See, e.g.*, Marco Da Rin et al., *Public Policy and the Creation of Active Venture Capital Markets*, 90 J. PUB. ECON. 1699 (2006).

71. *See, e.g.*, BISHOP, *supra* note 62, at 270.

72. Dirk Engel & Max Keilbach, *Firm-Level Implications of Early Stage Venture Capital Investment—An Empirical Investigation*, 14 J. EMPIRICAL FIN. 150, 151 (2007).

73. *See, e.g.*, William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990) (defining venture capital as "a professionally managed pool of capital that is invested in equity-linked securities of private ventures at various stages in their development").

74. In addition to those we discuss in detail, there is a fourth function that venture capital firms perform. Venture capital firms support endeavors that might not otherwise receive financing. As obvious as this might seem, the role of venture capital as *capital* is critical, particularly in poor countries, and especially with respect to highly innovative and risky ventures. *See, e.g.*, Robert D. Cooter, *2005 Mason Ladd Lecture: Information, Innovation, and the Poverty of Nations*, 33 FLA. ST. U. L. REV. 373 (2005).

management consulting firms, at least with respect to the recipients of their investment. This transfer of knowledge is difficult to quantify but can be fundamental to the success or failure of a start-up firm. Finally, venture capital firms, for reasons we explain below, can act as quasi-watchdogs within new or growing enterprises. We devote the remainder of this Part to an analysis of how the venture capital model accomplishes each of these important functions. In the next Part, we show how the MSIA might be structured to perform similar functions.

1. Searching and Sorting

In the parlance of the venture capital world, one of the principal objectives of a venture capital firm is "deal flow."[75] This requires the identification of entrepreneurs with innovative ideas and small enterprises with highly promising business plans. VC firms must possess (or hire) the technical skills to evaluate the quality of, and potential market for, an entrepreneur's ideas. For example, to find and evaluate the best ideas at the earliest possible stage, VC firms send representatives to conferences,[76] locate themselves nearby to universities and university-related research parks,[77] and employ their own in-house specialists to evaluate proposals.[78] All of these examples require the financier to possess expertise in substantive fields, as opposed to merely possessing financial expertise (important though it may be). Additionally, VC financiers must be proactive in seeking investment opportunities rather than passively waiting for potential customers to find them. To be clear, we do not argue that VC firms never receive unsolicited requests for assistance; indeed, VC firms receive thousands of pitches every year. Instead, we argue that the most successful VC firms seek ideas, rather than wait for ideas to come to them. While we recognize that some of the venues VC firms typically use for access to good ideas (e.g. high-level conferences and well-funded universities) may not exist in many African states, individuals from those states often attend conferences

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75. *See, e.g.*, Yael V. Hochberg et al., *Whom You Know Matters: Venture Capital Networks and Investment Performance*, 62 J. FIN. 251, 252 (2007) (defining "deal flow" as the ability to "select promising companies" and stating that it is "one of the two main drivers of a" venture capital firm's performance).

76. *See, e.g.*, Rich Mintzer, *Where Ideas Meet Investors*, MSNBC, Mar. 6, 2009, http://www.msnbc.msn.com/id/29550643/.

77. *See, e.g.*, Albert N. Link & John T. Scott, *The Economics of University Research Parks*, 23 OXFORD REV. ECON. POL'Y 661 (2007).

78. *See, e.g.*, Michael E. Porter, *Clusters and the New Economics of Competition*, 76 HARV. BUS. REV. 77 (1998).

and attain schooling abroad. These individuals would form self-selected talent-pools from which the MSIA would draw.

2. Management Assistance

Venture capital firms typically invest in very early stage enterprises. When a venture capital firm invests in a start-up, it usually takes an active role in managing the enterprise.[79] This involvement can take a variety of forms. For example, VC firms commonly place a member of the VC firm on the start-up's board of directors. For earlier-stage enterprises, the VC firm's involvement might entail providing regular advice or assistance regarding accounting, marketing, or any number of other issues relating to the commercialization of the entrepreneur's idea.[80] Regardless of the specific issues on which assistance is provided, two considerations are important. First, the VC firm's assistance is tailored to the specific needs of the new enterprise. It is flexible and responsive to the challenges and deficits faced by that enterprise, which can vary over time and among firms. Second, because their fates are intertwined, the VC firm has the same incentives as the new enterprise.[81] Thus, the new enterprise should be receptive to the VC firm's advice. This is not to suggest that no conflict is possible or that the investor's interests do not diverge from the enterprise's interests over the long-term. Both are possible. However, what matters is that, in most instances, the VC firm and the new enterprise will define success in the same way.

3. Oversight

Entrepreneurs wishing to develop their ideas into businesses can seek financing from banks or venture capital funds.[82] The entrepreneur's financing decision is significant to the future success or failure

79. *See, e.g.*, Michael Gorman & William A. Sahlman, *What do Venture Capitalists Do?,* 4 J. BUS. VENTURING 231 (1989).

80. *See, e.g.*, Dimo P. Dimov & Dean A. Shepherd, *Human Capital Theory and Venture Capital Firms: Exploring "Home Runs" and "Strike Outs,"* 20 J. BUS. VENTURING 1, 4-5 (2005) (identifying the various management-related tasks performed by venture capitalists for their portfolio companies).

81. *See, e.g.*, Gilson, *supra* note 17, at 1072 (noting that venture capital funds are "expected to make important noncash contributions to the portfolio company . . . [including] management assistance, . . . [and] intensive monitoring of the portfolio company's performance").

82. Many early-stage entrepreneurs also receive financial capital from what some call the three F's: "family, friends, and fools." Robert D. Cooter, *Innovation, Information, and the Poverty of Nations*, 33 FLA. ST. U. L. REV. 373, 377 (2005). Although such financing is surely important, we do not consider it here.

of the new business. Bank financing is typically in the form of debt and thus requires an obligation to repay the funds.[83] In VC contracts, VC firms typically receive some form of equity in exchange for financial capital.[84] There are myriad implications that flow from this difference,[85] but we focus on one area in particular: an equity stake typically provides greater incentives and greater opportunities to ensure that the new enterprise is managed competently and complies with the law.[86] By embedding itself in the new enterprise, the VC firm is positioned to know and influence the decisions made by the managers.[87] This is certainly no guarantee that the new enterprise will never violate the law or o therwise engage in unethical behavior. However, the VC firm's equity stake compels deep concern for the long-term health and value of the new enterprise.

B. *Reasons the MSIA Would Be Better Than Likely Alternatives*

Our proposal is a tool to facilitate state, investor, and international organizational mitigation of the harms caused by wealth transfers to countries that lack the social capacity necessary to ensure that such transfers result in economic growth. In the remainder of this Part, we show why our proposal is a good means to accomplish these goals. Before demonstrating ways that our approach might be preferable, it is useful to suggest how our model will differ from the likely IFC approach. The IFC has not yet publicly released any details about the form of its new endeavor. However, by way of speculation, two features of the IFC's prior work are most important. First, despite its focus on private sector investments, the IFC nonetheless must work with host country governments; indeed, its charter requires it to forego any

83. *See* Masako Ueda, *Banks Versus Venture Capital: Project Evaluation, Screening, and Expropriation*, 59 J. FIN. 601, 601 (2004) (describing choice of financing).

84. *See* Andrew Winton & Vijay Yerramilli, *Entrepreneurial Finance: Banks Versus Venture Capital*, 88 J. FIN. ECON. 51 (2008).

85. For a useful summary of the literature regarding the differences between debt and equity financing, *see id.* at 52.

86. *See, e.g.*, Ueda, *supra* note 83, at 601-02 & n.1 (summarizing literature indicating that, when compared to bankers, venture capitalists possess "the technical knowledge about the industries in which a venture capitalist has been investing," permitting them to better evaluate and manage firms in that industry).

87. For a survey of the literature demonstrating that venture capital firms engage more actively and frequently with their investees than do banks, *see* Winton & Yerramilli, *supra* 84, at 52 & n.2 (noting, for example, that venture capitalists monitor their investment enterprises an average of 18.7 times per year, while banks monitor their lending recipient firms an average of one or two times per year).

project to which the host country government objects.[88] This restriction, while perhaps appropriate given the large-scale infrastructure projects the IFC often supports, would unduly restrict the options available to local entrepreneurs and enterprises and place too much power in the hands of the host country governments. Our model bypasses the government and provides financial capital directly to enterprises, thereby reducing the opportunity for government interference and reducing the incentives for patronage-related corruption. Second, the IFC typically invests in large-scale projects. Our model targets small- and medium-sized enterprises. The recent history of development policy is rife with failed approaches, but microfinance is one of the few bright spots. For reasons we suggest below, investment in smaller enterprises appears to do more good, at a lower cost, than the large-scale projects often pursued by international financial institutions.

1. Direct Engagement with Private Enterprises

Over the past two or three decades, the World Bank and other international development and financial institutions have increasingly turned their attention to the quality of institutions in beneficiary countries.[89] Other things equal, a country with stronger institutions is likely to see greater and more durable improvements in economic conditions and social welfare than a country with weaker institutions.[90] On this account, institutions appear to play two important roles: they reduce the opportunities and incentives for political corruption and they help to create the conditions for individuals and communities to set and enforce norms and facilitate economic activity.[91] Put slightly differently, political accountability and civil society institutions help to ensure that political leaders are sensitive to ordinary people and help to

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88. *See* IFC, *Articles of Agreement*, art. III, § 3(ii), Apr. 28, 1993, *available at* http://www.ifc.org/ifcext/about.nsf/AttachmentsByTitle/articles.pdf/$FILE/articles.pdf ("[The IFC] shall not finance an enterprise in the territories of any member if the member objects to such financing.").

89. *See* Deborah Brautigam, *Governance and Economy: A Review* (World Bank, Policy & Review Dep't, Working Paper No. 815, 1991), *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1991/12/01/000009265_3961002050636/Rendered/PDF/multi0page.pdf.

90. *See, e.g.*, Cheryl W. Gray & Daniel Kaufmann, *Corruption and Development*, FINANCE & DEVELOPMENT 7 (1998).

91. *See, e.g.*, Daniel Kaufmann, *Rethinking Governance: Empirical Lessons Challenge Orthodoxy*, (World Bank, Discussion Draft, March 11, 2003), *available at* http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/rethink_gov_stanford.pdf.

provide the platform for individual initiative to increase social welfare.

The conventional approach to development assistance has come to include measures to improve both kinds of institutions.[92] What unites these efforts, and is generally true of the conventional approach to development and institutions, is the direct engagement of the problem institutions in an attempt to improve them.

Our approach is different. We propose that the MSIA invest directly in private enterprises irrespective of the host country's relationship with the IFC or the World Bank. This would reduce the likelihood that a ruling regime could stand in the way of an investment that might, for example, enhance social welfare but also strengthen its political opponents. By bypassing, or at least reducing, state involvement, our proposal would provide more opportunity for enterprises to develop in ways that were responsive to local concerns and needs rather than merely useful for the ruling regime. This would certainly not guarantee the success of every new enterprise or ensure that new enterprises would never engage in socially-harmful activities. But, our approach would help to enhance the vitality of communities and small-scale entrepreneurs as opposed to providing yet another revenue stream for states.

Our approach has an additional benefit, which is perhaps best understood in the context of the venture capital model. Recall that this model has the ability, along with both the expertise and incentive, to ensure that the new enterprise complies with the laws and good business practices because the venture capital firms is embedded in the new enterprise. This salutary feature of the venture capital model would provide no guarantees, but it would help increase the enterprise's likelihood of success (and long-run value). And, perhaps most important, it might help forestall a host country's sovereignty-based objection that the MSIA was attempting to meddle in local matters. Because the MSIA's investment would be valuable only if the enterprise succeeded, and because success would depend on largely local conditions, the MSIA would have every incentive to help the recipients of its investments comply with local laws and be responsive to local demands.

2. Leveraging the World Bank Group's Strengths

One useful feature of the venture capital model is that it shows the importance of actively seeking investment opportunities rather than passively awaiting requests for assistance. One component of this feature is the need for the investor to possess substantial expertise in the techni-

92. *See* Brautigam, *supra* note 89.

cal issues most important to the new enterprise's business plan. Our MSIA proposal would have the capacity to do both of these things. First, because the World Bank Group in general and the IFC in particular already possess substantial expertise in Africa's private sector, the MSIA would be in a good position to identify good investments from its inception (and have the ability to attract more talent as well). Second, the IFC already provides services akin to management consulting and has developed substantial expertise in this area. What sets our approach apart from the IFC's typical approach is the MSIA would use this expertise on behalf of smaller enterprises. These enterprises are most likely to succeed, most likely to actually enhance social welfare, and least likely to contribute to the state-level corruption issues that are so prevalent in Africa.

3. The Potential of Micro- and Meso-Finance

The IFC has, for much of its history, invested primarily in large-scale projects. The history of such investments is decidedly mixed. Recently, the IFC has begun to show more flexibility in its investments. For example, it now has a program that specifically targets, and provides management and marketing assistance, to smaller enterprises.[93] Our approach with the MSIA is to hasten and enhance the move toward smaller enterprises. Instead of encouraging or suggesting engagement with smaller enterprises, the MSIA would be charged with identifying small- and medium-sized businesses and new entrepreneurs for investment. This approach, while again not providing a guarantee of success, would be consistent with the best available evidence, which shows that micro- and meso-finance are two of the very few development models that actually appear to be helpful to local people.[94]

III. Possible Complications and Objections

This concept and the institutional design features we have suggested naturally raise a host of issues and potential objections. In this Part, we anticipate and respond to three of these issues. One possible objection to

93. *See* IFC, Creating Opportunities in Emerging Markets: Microfinance (2008), *available at* http://www.ifc.org/ifcext/gfm.nsf/AttachmentsByTitle/M-Trifolds/$FILE/M-Trifolds.pdf.

94. *See, e.g.*, Robert Cull et al., *Microfinance Meets the Market*, (World Bank Dev. Research Group, Policy Research Working Paper No. 4630, 2008), *available at* http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2008/05/27/000158349_20080527095250/Rendered/PDF/wps4630.pdf (describing the history of microfinance and its contributions to economic development).

our proposal is that it is conditionality dressed in new clothing. Our response is that we are not advocating the kind of conditionality imposed by the IMF in the 1980's and 1990's. Instead, we advocate the creation of tools that would permit political or market conditions to discipline investors and states alike. A second potential objection is that our proposal is a call for a return to the days when African states were dominated by foreign corporations. In light of the history of foreign involvement in Africa, we take this concern seriously, but we argue that our proposal simply does not do this. Instead of being transfers of power from states to foreign corporations, it would actually amount to transfers of power from ruling regimes to citizens, by providing citizens with a path to prosperity that did not depend on the state. The final objection we anticipate is that our proposal is simply impractical. Even if Robert Zoellick wants sovereign funds to invest in Africa, they will not do so unless those investments are likely to generate a solid return. We argue that our institutional design, along with a handful of features of the market for capital in Africa, make our approach at least plausible. Other complications are sure to arise, but they must be left for another day.[95]

A. *Conditionality and Market Discipline*

Transfers of funds to developing countries—whether in the form of loans, grants, or financial investments—have often come with conditions attached. For example, during the Cold War, much of the aid that flowed from the United States or the former Soviet Union was designed to shape the behavior of the recipient state to ensure that it was consistent with the donor's strategic interests. After the fall of the Berlin Wall, the United States faced less strategic competition, and its aid became less focused on narrow security considerations and more on broader efforts at promoting democracy.[96] Similarly, assistance from international institutions, including the World Bank and the International Monetary Fund, has come with conditions on recipient-

95. One example might be that the MSIA, limited as it would be to 1% of sovereign funds, could actually reduce the amount of capital from SWF's invested in Africa. Such concerns might have relatively simple solutions. For example, the MSIA could manage no less than x amount of funds, with x being the amount of sovereign wealth invested in Africa at the date of the MSIA's establishment.

96. *See, e.g.*, James Meernik et al., *Testing Models of U.S. Foreign Policy: Foreign Aid During and After the Cold War*, 60 J. POL. 63, 64 (1998) (concluding, based on empirical analysis of U.S. foreign aid allocations, that "security-driven goals have become less critical and ideological goals more important with the passing of the Cold War. . . . [T]he United States is increasingly rewarding democratic states with foreign aid while reducing assistance to strategically important nations.").

countries that have long been criticized.[97] Having recognized that their assistance has not been as effective as expected, the World Bank and IMF have both undergone significant reforms with respect to the content and form of conditionality.[98] Conditionality reforms at both institutions now call for fewer and better justified conditions that are more narrowly-tailored and appropriate for the recipient country.[99] Putting to one side the substance of the conditions associated with foreign aid, what is important is that well-developed conditions are a critical tandem with aid if wealth transfers are to be effective.

Beyond the involvement of other states, market discipline imposes another set of potential conditions on investments and can come in a variety of forms. For example, when a corporation decides to invest in a foreign asset, it might insist on explicit assurances from the host country that it will do nothing to undermine the value of the investment. This might take the form of acceding to a bi-lateral investment treaty with the investor's home state, promising preferential tax status, or including stabilization clauses in investor-state contracts.

Another kind of market condition is less explicit but more powerful. The kind of business climate a state fosters goes a long way toward determining whether investors wish to risk their capital in that state. Put another way, the desire to attract investment, and to determine the kinds of investments it attracts, can influence state policies in powerful ways.[100]

97. The World Bank and IMF have been criticized for their cumbersome conditions. Generally speaking, criticism has come in three areas: (1) for requiring particular economic policies that may not be beneficial to the receiving country (e.g. requiring the privatization of a well-run public sector); (2) for being overly specific; and (3) for the sheer quantity and complexity of conditions associated with loans and development assistance. For an extended discussion of these issues, *see* WILLIAM EASTERLY, WHITE MAN'S BURDEN: WHY THE WEST'S EFFORTS TO AID THE REST HAVE DONE SO MUCH ILL AND SO LITTLE GOOD 6-30 (2006).

98. Shantayanan Devarajan et al., *Overview*, *in* AID AND REFORM IN AFRICA: LESSONS FROM TEN CASE STUDIES 6, 24-27 (Shantayanan Devarajan et al. eds., 2001) (affirming the irregular correlation between economic policy conditions and effective use of funds and advocating for country-owned development strategies).

99. Both institutions have on-going programs aimed at addressing these critiques. *See* WORLD BANK, CONDITIONALITY IN DEVELOPMENT LENDING POLICY (2007), *available at* http://siteresources.worldbank.org/PROJECTS/Resources/40940-1114615847489/Conditionalityfinalreport120407.pdf (reporting on the World Bank's progress on their Good Practice Principles for conditionality in development policy lending); IMF, GUIDELINES ON CONDITIONALITY (2002), *available at* http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf (outlining the IMF's Guidelines on Conditionality, which were the result of significant criticism of the IMF's conditionality practices).

100. For a comprehensive analysis of the ways in which a state's desire to attract commercial activity can influence its policies, *see generally* WORLD BANK, DOING BUSINESS 2009: COMPARING

A third variety of market conditions are those imposed by consumers and interest groups. Many consumers are sensitive to corporations' reputations for social responsibility, respect for the environment, or similar concerns.[101] With the exception of this last category, market conditions have typically been profit-oriented and, until recently, have precluded thorough consideration of the long-term benefits of the transparency, anti-corruption, and policy conditions we suggest for the MSIA.

Our proposal would bring to bear a range of constraints and incentives that would, taken together, increase the likelihood that investments in poor states actually benefit the citizens of those states. To be clear, we do not argue that corporations or other states should determine the social policy of the states that receive aid or are the targets of investments. Instead, in contrast to those who argue that aid is either positive or negative, or that resource revenue is either positive or negative, we argue that the principal determinants of whether wealth will have a positive or negative effect may be the character of the recipient and the conditions associated with the wealth. In our view, resource revenue can (and does), in the right policy and institutional environment, benefit citizens. Development assistance can (and does) benefit recipients under the right conditions. Private investment can (and does) benefit target states under the appropriate conditions. Our aim is to create those conditions.

B. *Corporations in Africa*

The history of corporate involvement in Africa is rife with stories of abuse and exploitation. From the devastating effects of the unspeakable horrors of the slave trade[102] to the parastatal enterprises developed during the colonial years,[103] examples abound of the ways that corporate activity made life worse for ordinary people in many states in Africa. And the recent history of corporate activity in Africa shows that

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REGULATION IN 181 ECONOMIES (2009), *available at* http://www.doingbusiness.org/Documents/FullReport/2009/DB_2009_English.pdf.

101. *See, e.g.*, Paul A. Argenti & Bob Druckenmiller, *Reputation and Corporate Brand*, 6 CORP. REPUTATION REV. 368, 372-73 (2004) (presenting results of qualitative empirical research suggesting that corporate managers seek to create socially responsible identities for their brands); Jill Gabrielle Klein et al., *Why We Boycott: Consumer Motivations for Boycott Participation*, 68 J. MARKETING 92, 93-95 (2004) (surveying research findings suggesting reasons for consumer boycotts).

102. *See* BASIL DAVIDSON, THE AFRICAN SLAVE TRADE (1988).

103. *See* RALPH AUSTEN, AFRICAN ECONOMIC HISTORY 122-46 (1987) (describing the role of corporations in creating quasi-states within Africa and the effects of this transformation on local people and economies).

the old problems remain.[104] Despite the continued importance of this history, we argue that there are two responses to these concerns. First, corporate activity continues in Africa and will certainly continue in the future. Our aim is to make it more likely to actually benefit local people and communities, mindful that it will never be without problems. Many of the worst abuses relating to corporate activity in Africa came about through collusion between foreign corporations and the state (or the colonial power). Our approach is a way to permit citizens to form partnerships with the MSIA, thereby circumventing the state, which has all too often facilitated the harm caused by corporations. Second, the conditions under which many of the worst abuses occurred have changed, making them less likely today.[105] To be clear, we do not argue abuse is impossible, or even particularly unlikely. Instead, we maintain that our proposal is more likely to do good and less likely to do harm than the available alternatives.

C. *Plausibility Concerns*

A final set of objections to our proposal is that it is implausible. This objection could take many forms, but we focus here on two: sovereign fund managers will not participate in the MSIA, unless its returns are equal to the returns available elsewhere, and states will object because channeling their investments through the MSIA would remove the strategic benefits they receive from their commercial decisions. In our approach, we consider sovereign fund managers to be separate from sovereign fund owners (which are states). This distinction supports the assumption that sovereign fund managers are motivated by returns, not by strategic issues, and that there is some room for states to incorporate strategic considerations in their commercial decisions.

We argue that sovereign fund managers will likely view the MSIA favorably for three principal reasons. First, the MSIA would certainly not foreclose other investment opportunities. Recall that Zoellick called for sovereign funds to invest only 1% of their assets in the as-yet-unnamed project. Thus, sovereign fund managers need not choose the MSIA over other options, but merely incorporate it as a small portion of an array of investments in a diversified portfolio. Second, all investors benefit from greater transparency and consistent

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104. *See* JOHN GHAZVINIAN, UNTAPPED: THE SCRAMBLE FOR AFRICA'S OIL (2007); HOWARD W. FRENCH, A CONTINENT FOR THE TAKING: THE TRAGEDY AND HOPE OF AFRICA (2004).

105. *See* Patrick J. Keenan, *Do Norms Still Matter? The Corrosive Effects of Globalization on the Vitality of Norms*, 41 VAND. J. TRANSNAT'L L. 327 (2008).

investment conditions. For example, it would be virtually impossible for an investor to appropriately value a possible investment if that investor does not know whether she will be subject to taxes that were the same, higher, or lower than others in the same market. The MSIA could help provide more information and transparency by embedding itself—and the transparency and anti-corruption practices required of World Bank Group projects—into the private sector in Africa at the local level. Finally, some investors may actually prefer the MSIA, particularly in difficult or fragile investment climates. If the MSIA were a partner in a multi-partner project, or if it were the conduit through which the sovereign fund invested, then the MSIA could play the important role of negotiating with the state if it were to attempt to solicit bribes or otherwise undermine the new enterprise. The presence of an institutional investor, particularly one that is part of the World Bank Group, might assuage some investors' concerns about how they would effectively engage with the host country government.

IV. Conclusion

Robert Zoellick's call for sovereign wealth funds to invest in Africa has the potential to mark the start of a new era of investment in Africa. Whether this investment improves the lives of ordinary people in Africa depends in large part on how the investments are structured and who receives them. We propose the formation of a new branch of the World Bank Group, which we have called the Multilateral Sovereign Investment Agency. The MSIA could receive investments from sovereign wealth funds and use those funds to invest in small- and medium-scale private enterprises in Africa. If structured appropriately, the MSIA could help ensure that investments in Africa actually, and finally, benefit ordinary people.