INSECURE CONTRACTS AND RESOURCE DEVELOPMENT

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Investment to develop the rich mineral resources of many Third World countries has declined significantly in recent years, in part due to rising fears of expropriation or forced contract renegotiation. All parties thereby forego great potential advantages. We argue that the host country-investor relationship is a member of a wider class of inherently unstable "insecure contract" situations, in which one party has reduced incentives to abide by the agreement after the other party has made an irrevocable first move. We analyze performance bonds, traditional political risk insurance, linkage, and prevention as possible means of stabilizing these contracts. We then sketch ideas for a new institution that would realign the parties' incentives to negotiate and maintain the terms of fair and mutually advantageous agreements. Principles and mechanisms emerge that can help resolve the instabilities that inhere in many analogous situations, from ceasefire agreements to government procurement practices to marriages and employment contracts.

Many Third World countries are having a hard time finding the means to develop their rich natural resources. Several years ago, some 60 percent of mining company exploration expenditure was in developing countries; more recently the figure has dropped below 15 percent.¹ Miners open up deposits of lower quality in


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developed countries and largely restrict their Third World efforts to a few "safe" developing countries. Elsewhere, commercially feasible deposits are left in the ground. This economically illogical situation harms less developed countries (LDCs), who need the revenues and employment from mineral development projects as well as the transfer of technology and managerial skills. The industrial countries have fewer, higher-cost sources of supply; their companies do less well. As a result, consumers pay inflated prices and face possible shortages.

We believe that investors' perceptions of "political risk" lead to much of this unhappy state of affairs. Aside from dramatic events such as those in Iran, there were over 500 expropriations around the world during a recent 15-year period. Less visible contract renegotiations have been forced on a much wider scale.

Some of these actions have been in response to grossly unfair terms inherited from colonial pasts. Others have more subtle explanations. Of course, unfair conditions need not be part of new investments. Joint gains from mineral development agreements are very possible. But surveys of businessmen and patterns of investment reveal that the fear of forced contractual change is now rampant. The swelling need for risk capital in LDCs goes largely un-

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4 By political risk, we refer to investment hazards such as expropriation, forced contractual changes, the enactment of new laws, decrees, or regulations that interfere with normal business activity, and so on. We do not refer to kidnapping or assassinations.


6 Among the many authors who have documented this trend, see Walde, Thomas W. (1978): "Revision of Transnational Investment Agreements: Contractual Flexibility in Natural Resources Development," *Lawyer of the Americas*, 10:274-279.

met; transfers of technology and management skills often do not take place.⁸ All parties forego great potential advantages.⁹

Along with other observers, we shall argue that this unfortunate situation arises in part from intrinsic features of the bargaining situation between mining companies and developing countries that render their agreements inherently unstable.¹⁰ In response to this

⁸Mikesell, "The Role of Foreign Private Investment in Future LDC Mining Projects," in Sideri and Johns, footnote 2, pp. 292-307, estimates that future capital needs for mining developments in the Third World will average $5.5 billion per year (1977 dollars), that current private foreign investment in LDC mining projects may be about $1 billion per year, and that it must reach $3.5 billion annually to meet the estimated need remaining after the expected contribution of development banks. After surveying a wide variety of potential capital sources, he concludes (p. 301) that "at the present time, it is difficult to see any alternative to the operations of mining MNCs for undertaking the bulk of the exploration in LDCs." For a similar conclusion, see Zorn, footnote 2, pp. 291-299; Radetzki, Marian, and Zorn, Stephen A., "Foreign Finance for LDC Mining Projects," in Sideri and Johns, footnote 2, pp. 177-197; and the Annual Report, The World Bank (1978). For a general discussion of the capital shortage in the Third World, see World Development Report, 1980, The World Bank (1980), pp. 24-31.

⁹There is considerable controversy over whether foreign direct investment in mineral exploitation is preferable to waiting until the LDCs are able to obtain capital to do the mining themselves. By waiting, one argument goes, LDCs would free themselves from foreign dependence as well as reap greater financial rewards. Many argue that the social and political considerations make multinational corporations undesirable agents for mineral exploitation. For forceful presentations of these arguments, see, generally, Girvan, Norman (1976): Corporate Imperialism: Conflict and Expropriation, White Plains, NY: M. E. Sharpe; and Tanzer, footnote 1, pp. 224-238.

The argument that foreign direct investment in mineral exploitation is undesirable may have merit. Several authors, however, suggest that as a practical matter LDCs are unlikely to obtain capital for mineral exploitation without recourse to multinational corporations (see footnote 8). In addition, postponing development carries a cost in foregone social and economic projects that could be financed with mining revenues. If LDCs' discount rates are high, as many suggest, such a delay may be very costly.

Contracts can be structured to transfer technology and managerial skills that should be useful in future endeavors as well as to provide revenues. To the extent that foreign direct investment now is preferable to waiting for capital, the scheme we propose should favor the long-run interests of LDCs as well as stabilize the supply of minerals.

We should also note that the effect of any contract on the development of a country may depend on the distribution of its benefits within the country. Mining operations whose rewards redound to a small number of individuals may not enhance development. These distributional issues are probably not within the purview of a mining contract and, in fact, raise a thorny dilemma for most types of external finance or development assistance.

diagnosis of "insecure contracts," we offer some preliminary ideas for a new institution that would realign the parties' incentives and allow mutual benefits to be realized.

There are many possible approaches to resource development in the Third World, including international commodity agreements, direct increases in the funds available for LDC mineral exploration, improved LDC access to capital markets, and a more satisfactory definition of the rights and obligations of multinational corporations.\footnote{Commodity agreements are discussed by Kirchner et al., footnote 10, pp. 79-83, 123-127. Funds for LDC exploration are proposed by Faber, Mike, and Brown, Roland (1980): "Changing the Rules of the Game: Political Risk, Instability, and Fairplay in Mineral Concession Contracts," Third World Quarterly, 2:100-119. Sources of finance and prospects for improved LDC access to capital are covered by Mikesell, in Sideri and Johns, footnote 2, pp. 297-307, and by Kirchner et al., footnote 10, pp. 113-122. For a discussion of the rights and obligations of multinational corporations, see "Formulations of the Chairman of the Ad Hoc Inter-Governmental Working Group on the Principles and/or Issues Related to the Activities of Transnational Corporations," U.N. Doc. E/C. 10/AC.2/8 (1978); or Vernon, Raymond (1979): "The Multinationals: No Strings Attached," Foreign Policy (Spring): 121-134.} In this article, we do not deal with these other approaches. Our scheme can either stand alone or can be implemented in tandem with several of these other potential solutions. However, it is designed specifically to address destabilizing features inherent in the investor-host bargain that will remain even if other approaches are adopted simultaneously.

At the core of an insecure mining contract lies a characteristic bargaining game that, like the famous "prisoner's dilemma," has implications for situations far beyond its original context. In analyzing the problem of mineral development, therefore, the principles and mechanisms that emerge can help resolve the instabilities that inhere in a host of other insecure contract situations, from ceasefire agreements to government procurement practices to marriages and employment contracts.

\textit{The Renegotiation or Expropriation Decision: Motivations, Benefits, and Costs}

Insecure contracts are characterized by a shift in bargaining power from one party to the other over the life of the contract. Before a mining contract is signed, the company has significant leverage on
its terms simply by virtue of its option not to proceed. Once the
fixed investment of several hundreds of millions of dollars is in
place, however, bargaining power shifts significantly to the host
government. In Vernon’s phrase, there is an “obsolescing bargain.”

Beyond the sense of unredressed wrongs that may endure from
an unhappy colonial history, there are at least five diverse aspects
of the bargaining situation between a host country and a mining
company that can lead to politically untenable profits and calls for
renegotiation as the host’s bargaining power grows. These merit
brief enumeration.

First, all parties are acutely aware that mining is a risky business.
There are expensive failures, such as Zaire’s Tenke-Fungurume
development that suffered a $200 million loss. Companies are
not bashful about demanding compensation for undertaking such
risks. If a mining operation is successful, handsome profits may be
earned. Yet, even with returns at high levels, investor payback may
take several years. After the investment is made, however, the
“sunk risk” of possible early failure is forgotten and with it goes
any political legitimacy for extended high rates of return.

Second, in the initial contract negotiations, uncertainty about
the proposed project abounds—about deposit extent and quality,
about investment timing and costs, as well as about the future of
mineral prices. Such information as does exist on these uncertain-
ties may be held predominantly and strategically by the mining
company. It may be used by experienced company negotiators to
obtain especially favorable terms.

Third, fears of “political risk” may drive companies to demand
“risk premiums” against the possibility of forced contractual
changes. These premiums can take the form of still more one-sided
financial terms that, themselves, may later exacerbate demands for
renegotiation.

Fourth, the terms that were negotiated when the country’s bar-
gaining position was weak may later come to be seen as unfair.
The standards for what constitute a reasonable rate of return may
change both as the host’s power increases over time and as terms
evolve in other, comparable mining countries.

Fifth, the contracts, which may be inordinately long (99-year
contracts are not unheard of), may rely on traditional taxation in-

12 See Zorn, footnote 3, p. 241; or Mikesell, footnote 8, p. 301.
struments such as fees and royalties rather than on more contingent mechanisms like progressive profit-sharing. With the dramatic price fluctuations typical of modern metal markets, these rigid contracts may produce booms and busts in company profitability. The booms can generate irresistible renegotiation pressure, while the busts threaten the mine's financial survival.

Beyond these reasons why unsustainably high rates of return may come about, a country's powerful yearnings for sovereignty over its own natural resources can add to renegotiation pressures. The desires for ownership of, control over, and participation in resource development are pervasive. Renegotiation forcefully expresses these sentiments. The political need—especially where there is a vocal opposition—to appear powerful, to act decisively, and to respond to domestic unrest may suggest foreign investors as useful targets. Especially if there are suspicions of excess profits accruing to a foreign entity that is exploiting the national patrimony, contractual changes or expropriation may be attractive to the host.

In short, as the host's bargaining power grows, renegotiation beckons in response to a sense of exploitation, the imperatives of sovereignty, and the promise of great rewards. And for the host, few costs appear to counterbalance the factors favoring forced changes.

Direct sanctions by the investor's home government are rare. For example, from 1960 to 1972 the Hickenlooper amendment forbade U.S. aid to countries that expropriated U.S. property without compensation, yet aid was suspended only once (to Sri Lanka). Military action poses a still more remote threat.

Because there is no accepted international mechanism for enforcing compensation after an involuntary renegotiation, the costs of altering contractual terms may be diffuse and delayed. The

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13 See, for example, Walde, footnote 6, pp. 279-287.
16 Some observers, such as Girvan, suggest that expropriation attempts are inhibited by potential reprisals by the investor or his home government. Vertical integration of the in-
chance of deterring some unidentified, potential investor who might be interested in a deposit that is as yet undeveloped (or even undiscovered) does not loom large compared with the immediate advantage of taking a larger share of the returns from a visible, profitable concern. This perception may be doubly strong for government officials with short time horizons. Moreover, after a mine has been operating for a while, local capabilities to run it are increased and the lure of a total takeover rises.

The country-company bargain looks to the country like an isolated, one-shot, bilateral affair. Tangible and immediate benefits are weighed against uncertain, future costs. The "rational" decision— to force changes— results. But potential investors' perceptions of "political risk" are not limited to the renegotiating country; these fears spread and spill over to affect other LDCs as well. Investment begins to dry up. The very nature of this situation now creates great difficulties for many LDCs, regardless of their own histories or their intentions to commit themselves convincingly to fair contract terms. Bad faith is not the question; instead, the very structure of the negotiating relationship seems inexorably to lead to untenable contracts and uncontrollable renegotiation pressures.

By focusing on the current bargaining situation, we do not mean to underestimate the importance of its historical, political, and social roots. Insecure contracts are, however, a structural problem that we may address directly. The solution we propose is generic; its principles apply to other cases of insecure contracts.

*The Structure of an Insecure Contract*

Figure 1 captures the strategic essence of an insecure contract by

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17 The general trend of mining investment away from the Third World (footnotes 1, 2, 7 and 8) does not imply that all LDC investment is in decline. For example, despite the nationalization of the International Petroleum Company in Peru, other oil investors quickly returned to that country. But for nonfuel mining investments, which have much heavier fixed capital requirements and much longer payback periods, political risk is a potent deterrent.
**Figure 1. ANATOMY OF AN INSECURE CONTRACT.**

Note: The MNC may choose to invest or to stay home. If it stays home, payoffs for both parties are equal to zero. If it invests, the LDC decides whether to renegotiate or not. Only the ordering of the payoffs by their magnitudes has significance; the particular values are shown only for expository convenience. In fact, detailed and highly uncertain estimates of costs and benefits over a long time period would be required. Moreover, the reduction of the investment relationship to two discrete decisions is also a drastic simplification of reality.

means of an interactive decision tree.\(^{18}\) The multinational corporation (MNC) may choose to invest in an LDC or to stay home. The LDC makes a decision only if the MNC decides whether to invest; then the LDC decides whether to renegotiate. This sequence of decisions has three possible outcomes: (1) investment followed by renegotiation, (2) investment without renegotiation, and (3) no investment. The MNC prefers investing without LDC renegotiation over staying at home. Renegotiation ranks last. The LDC, on the other hand, wants investment and may try to attract it by promising not to renegotiate. Should the MNC decide to invest, however, the LDC has no payoff incentive to abide by its promise. Knowing this, a wary MNC may choose to stay home.

Analogous insecurities reside in the structure of many nonmin-
ing bargains. The Israelis might wish to return the strategic Golan Heights to Syria in exchange for a promise of peace. They may fear, however, that the promise could not be enforced should the Syrians later resume hostilities. Similarly, after a few years as the sole source on a vital defense contract, a large contractor may be in a powerful position to demand more lucrative terms from the government, which may have to accede or risk a costly failure. Or, after leaving his old job and moving to a new part of the country, an employee who finds that his new job is not as was promised may be powerless to correct the situation. An agreement to have a child only if the father shares its care may evaporate once the baby is born, with all the responsibility falling to the mother. Each of these "contracts" is insecure because one party's incentives to abide by its terms are reduced after the other party has made an irrevocable first move (e.g., digging the mine, giving up the Golan Heights, making the sole source contract award, moving across the country, or having the child).

Any resolution of the problem of an insecure contract requires a change in the relative magnitudes of the payoffs. In the case of mining, only if the LDC's payoff for not renegotiating exceeds its payoff for doing so will a rational LDC be less likely to renegotiate; that likelihood is critical for the MNC. If a renegotiation in fact occurs, despite the MNC's prior perception of its probability, the MNG can be compensated by raising its relevant payoff.

In our subsequent analysis of four possible approaches to problems that have this structure, we judge possible solution schemes by examining their effects on both the LDC and MNC payoffs. Because we are especially interested in the investment decision, we evaluate the effects of proposed solutions by focusing on two criteria: (1) the relative magnitudes of the LDC payoffs for renegotiating or not, which, from the MNC's perspective, influence the probability of renegotiation; and (2) the MNC payoff in the event of a renegotiation.

*Possible Approaches*

Principal methods for dealing with the instability of insecure con-
tracts include performance bonds, insurance, linkages to other parties and activities, and prevention.

PERFORMANCE BOND

An obvious way for the country to commit itself convincingly to the terms of a contract is to post a bond (with a value higher than the proposed investment) with a trusted third party. If the terms are abrogated, the bond reverts to the company. Both MNC and LDC payoffs in Figure 1 are changed. Two separate effects of this idealized solution are important: (1) the company is compensated in the event of adverse action, while (2) because the host pays this compensation, its incentive to renegotiate decreases. The MNC's perceived probability of such a change is greatly reduced. In principle, then, a performance bond meets our twin criteria.

There are two serious practical problems with this proposed solution. First, it is far too expensive for most developing countries to post a bond in an amount that exceeds the present value of the mine's output. Second, the willingness of both the LDC and the MNC to accept a performance bond depends on who will decide whether a violation has occurred. Both parties must trust this decision-making process and accept the legitimacy of the decision. Many sovereign states are loath to permit outside arbitration of matters occurring within their jurisdictions. Particularly in Latin American countries, this belief is held strongly enough to have acquired a name—the "Calvo doctrine." A proposal that a country post a large bond that is hostage to the decision of a third party would likely founder on these shoals.

INSURANCE

So why not draw up a simple insurance contract that would compensate the company in the event of contractual changes? This

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19 Of course, in order to reduce the expense, the country could post the bond, and, in order to have the use of the money, borrow it back, paying only the interest. Or the "bond" could be in the form of a contingent "loan" from, say, the World Bank, that would be made automatically to compensate the MNC in the event of a renegotiation.

20 For example, see Vernon, footnote 11, p. 131.
would increase the company's payoff in the event of a renegotiation (say, from -1 to 0 in Fig. 1). In the framework of Figure 1, however, insurance would not change the LDC payoffs and, thereby, the probability that the country would force a renegotiation. From the point of view of the potential mining company, of course, the perceived probability of renegotiation may be just as important as the amount of compensation. In principle, though, if renegotiation triggered a large insurance payment, which in turn visibly reduced LDC payoffs by making necessary coverage for future investments in the country hard to obtain, then renegotiation would be less likely.

The actual effects of political risk insurance on the probability of a forced renegotiation are not clearcut. By reducing the financial impact on a company in the event of a renegotiation, coverage may actually make such actions appear less risky for the host country and hence, more likely. The insurance companies are somewhat isolated economic actors; they have few potent linkages with or sanctions against countries that force renegotiation. Any deterrent effect follows from the insurer's possible denial of insurance to subsequent ventures in the country. But there are many governments and private insurance companies writing political risk insurance. The information about which countries have forced renegotiations may not circulate. In any case, most current political risk schemes are addressed to expropriation; they do not even cover renegotiation.\textsuperscript{21}

\textbf{LINKAGE}

If a host country believes that forcing a renegotiation hurts other parties who would be likely to retaliate, the host will be less likely to take such measures in the first place.\textsuperscript{22} That is, the direct linkage between a renegotiation with one firm and other companies' or governments' actions could reduce the host's relevant payoff in


\textsuperscript{22}In subsequent discussions, we omit the important but obvious point that existence of a link between a renegotiation and retaliation is not enough. The host must believe that the link exists in order to respond appropriately.
Figure 1, and, hence, the chances of a renegotiation. Linkage, however, does not increase the company’s payoff in the event of renegotiation.

A company considering investment in a country also might wish to use a variety of financial and contractual mechanisms indirectly to link parties (such as banks, corporations, and other governments that have dealings with the host) to the successful completion of the project. Investors sometimes go to extraordinary lengths to set up indirect links that may raise the price in other spheres to the host of a forced renegotiation.\footnote{For examples, see Moran, Theodore H. (1975): "Transnational Strategies of Protection and Defense by Multinational Corporations: Spreading the Risk and Raising the Cost for Nationalization in Natural Resources," \textit{International Organization}, 27:277; or Fruhan, William (1979): \textit{Financial Strategy}. Homewood, IL: Richard D. Irwin, pp. 129-148.} In practice, private attempts at such links have not been very successful because the adverse effects of these links were usually diffuse and delayed.

\textbf{Prevention}

Of course, the easiest way to avoid the insecure contract problem is to prevent its occurrence by reducing the disparity between the relevant LDC payoffs in Figure 1. While this end cannot be achieved entirely, measures such as fiscal provisions that are progressive and contingent can reduce the apparent gain from renegotiation. Other measures that increase the host’s control and participation can also prevent too wide a gulf from opening between the payoffs for renegotiation and those for not doing so.

\textit{A Proposal}

We propose a multilateral insurance scheme against political risk that makes use of the following observations:

(1) Several parties share an interest in successful resolution of the insecure contract problem. Miners, developing countries, and developed countries would all benefit—and should be willing to contribute something to a solution.
(2) Despite regime changes and political pressures, most countries try very hard not to default on their loans because the adverse consequences are immediate and obvious. The next trip to the international bank window—for dams, roads, schools, or whatever—may be met by stony silence or outright refusal. Can we convert the country’s promise to eschew forced renegotiation into a form that links it directly to capital markets? This linkage could tie the terms of mining sector contracts to other capital-hungry sectors of the country’s economy.

(3) The norm of solidarity is strong among the LDCs and particularly among some regional groups. Can we tap this solidarity by giving other LDCs a partial stake in the terms of sister countries’ contracts?

We observed above that a performance bond provides a possible remedy for an insecure contract because it reduces the probability of renegotiation and compensates the aggrieved party if such an event comes about. Insurance compensates only the aggrieved party, while linkage serves merely to reduce the probability of renegotiation. Therefore, we combine insurance and linkage to reap the advantages of a performance bond without its drawbacks of expense and possible affront to sovereign sensibilities. While fully conscious that in actual practice such a scheme would encounter daunting problems, we nonetheless offer a tentative framework and principles for its operation.

A union of LDCs possessing potential resources, international financial institutions, developed countries, and mining companies would be formed. Members of this union would contribute to a fund and would agree to compensate mining firms that were subject to forced contract renegotiations.

When a project is proposed in a member country, the union would offer a technical staff to help the host negotiate a fair contract with sensible and advantageous features. These typically should include progressive and contingent fiscal provisions as well as numerous devices to provide the reality and appearance of

\[24\] For example, no defaults or repudiations of World Bank loans have occurred. See Kirchner et al., footnote 10, p. 115.
sovereignty, control, and participation to the LDC host. Currently, such features are often absent from these agreements.

To be eligible for the scheme, the contract would be submitted to a union board for review and certification. The board, which would have substantial LDC membership, would be responsible for determining whether the contract's provisions could likely be sustained without renegotiation. The board would ensure that the contract was in line with current mining practice, that it was not of excessive duration, that its fiscal provisions were contingent and could adjust automatically to changing circumstances, and that the opportunity was afforded to the host for transfer of technology and management skills.\(^\text{25}\) The contract should also contain a method for determining the value of the mine to allow the host to obtain equity on a phased basis, thus increasing its participation and control. The same method could be used to determine compensation in the event of a forced renegotiation.\(^\text{26}\) If the contract were approved, the mining company would pay special insurance premiums to the union.

Because the board would be charged with protecting the insurance scheme from taking on bad risks including unfair or inflexible contracts, its incentives would be to scrutinize proposed contracts carefully from the host's perspective. Certification by the board, which would contain a number of the host's peers, could also be useful to the host in defusing local political opponents' claims of sweetheart deals or the like.

To lessen the multinational-host aura of the undertaking, other members of the union might choose to contribute capital and to participate as limited equity partners in the mining venture.

A mediation/fact-finding/commercial arbitration service would

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\(^{25}\) There are many features that can inject flexibility into the workings of a contract, thereby defusing renegotiation pressures. For a detailed discussion, see Walde, footnote 6, pp. 265–298.

\(^{26}\) There may be conflict on this matter between cost-based criteria and standards based on expected future revenue. The Cerro Colorado buy-out or disinvestment provisions, for example, stipulate a basic price of eight times earnings. See Zorn, footnote 3, pp. 239–250. Also, see Frank, Isaiah (1980): Foreign Enterprise in Developing Countries. Baltimore: Johns Hopkins U.P., p. 108. For a survey of such provisions, see Walde, footnote 6, p. 292. We assume that the mining company would not agree to a valuation method that was too low while the certifying board would not allow an excessive price that might spur renegotiation, and, in any case, that would expose the overall insurance scheme to an undue liability.
be available under the auspices of the union. In the event of unresolved contractual disputes, this mechanism would be used to determine whether contract terms had been honored, and, if not, what should be the amount of the union’s payment to the aggrieved party. It would also determine whether genuine surprises in the operation of the contract had arisen that warranted revised provisions.\textsuperscript{27} Arbitrators could be chosen by mutually acceptable procedures; for example, each party might select an arbitrator, with the two chosen arbitrators selecting a third member for the panel.

The participating international financial institutions would collect general contributions from other union members along with premiums for specific projects, would establish appropriate reserves against contingencies, and would arrange for compensation to be paid when it was indicated by an arbitral panel. In effect, the financial institutions would take on an insurance function.

\textit{Rationale for the Proposal}

A performance bond posted by the host country would compensate the company in case of a renegotiation. At the same time, the bond, as a contingent liability of the host, would tilt the incentives away from renegotiation. The scheme proposed here uses insurance as a more financially feasible means of compensating the company. The host’s incentives to renegotiate would be reduced not by forfeiting a bond, but by its links to those who would have to pay the compensation.\textsuperscript{28}

If a host country were found to have breached the terms of a contract unjustifiably, payment by the other parties (union members) would be triggered. Such an event could cause a variety

\textsuperscript{27}To handle surprises, categories of material changes in fundamental circumstances could be set up in advance (such as changes in comparable agreements, international codes, market structure, or home country legislation) that might trigger specified renegotiation procedures.

\textsuperscript{28}To cover small issues that might not effectively involve linkage, we might ask countries and, perhaps, companies to post small bonds. The bond would revert to the injured party in the case of a breach of contract to provide compensation and reduce incentives for small violations. Of course, such bonds would have little effect on major disputes.
of painful repercussions for the host country—across the other sectors of its present and future economy that were linked to the financial institutions, and to its fellow LDCs who were equity partners. These consequences might include a clearer unfavorable signal to future potential investors, difficulty in obtaining subsequent insurance coverage, antagonism of needed sources of future capital, as well as irritation of the equity investors in the project. Even now, many developing countries regard mere arbitral decisions under World Bank auspices (that are not tied to any insurance scheme underwritten by the Bank) as carrying considerable weight with respect to prospects for future private investment, credit rating, and future Bank loans for their other projects.29 This is especially true in the current era of tightening credit limits for developing countries.30 By visibly and credibly linking renegotiations to these consequences, the scheme should discourage such acts.31

The union members must risk financial loss following a renegotiation in order for the linked consequences to be credible. Of course, the greater the potential loss, the less banks and other countries will want to participate in the scheme. Moreover, once they are involved, they may try to shed the risk by diversifying it away, reinsuring it, or seeking reimbursement of their potential payments by mechanisms such as the U.S. Overseas Private Investment Corporation. If they succeed, so that the financial consequences are less severe when compensation is triggered, then part of the scheme's purpose would be defeated. The specific linkage that is intended to reduce the probability of forced changes would be diluted. For the scheme to work, the coalition of countries and banks must be induced to take on and hold the risk of forced renegotiation.

This is where the other players would come in. Developed countries should be willing to pay good premiums to the group that is

30 See Zorn, footnote 2, p. 294; and Radetzki and Zorn, in Sideri and Johns, footnote 2, p. 179.
31 Note the significant differences that this scheme has with respect to political risk insurance underwritten by a single country or an individual private company, which does not have the broad-based leverage that characterizes the multilateral proposal.
absorbing (and, in the process, lessening) the political risk. So should miners and, to some extent, developing countries who want to be part of the scheme.

We believe that terms can be worked out that would make the deal attractive to all. There are likely to be some important differences among the parties that can be dovetailed into an agreement. Most countries entering in good faith into certified “fair” contracts will not expect to force changes. To the extent that the host country and other union members believe that the proposed scheme itself would make the probability of renegotiation low, moreover, payments to mining companies injured by a renegotiation would not loom large as a potential liability. The miners and their national sponsors, however, may perceive the probability to be higher and may therefore be willing to pay substantially more for protection. Corporate risk aversion on the part of the miners may further increase the amount they would contribute. These factors, along with the overall common interest in success, suggest that enough money could be raised to compensate amply those who take on and hold the remaining renegotiation risk.32

Redressing the Power Imbalance

As matters presently stand, there is a dramatic shift of bargaining power from the host to the investor over the life of a mining contract. This leads to insecure contracts that, in turn, fuel fears of political risk. When contracts are negotiated in this atmosphere, companies may demand “risk premiums” against the risk of forced changes. These premiums can take the form of yet more one-sided financial terms which, themselves, may exacerbate demands for renegotiation. Simply put, instability inheres.

The proposed system attempts to even out this power imbalance. It shifts a great deal of early bargaining power to the host by providing technical assistance that would diminish the

32 Financial institutions should have two separate incentives to take on an unaccustomed insurance role. First, there is the lure of generous compensation for holding the risk. Second, this scheme offers ways to make safer loans for otherwise attractive projects that now may be deterred by political risk considerations.
now common problem of lopsided contract terms. Only fair contracts would be certified as eligible for inclusion in the scheme. Because the certifying body is institutionally committed by protecting the insurance system from the bad risks of one-sided contracts, its approval incentives would be in line with those of the host. Because this board would have significant LDC participation, it would offer protection to local officials against opponents' inevitable cries of "giveaway!" The presence of a broader group of equity partners, even if only at a symbolic level of participation, would tend to diffuse the bilateral host-multinational aura of the undertaking. Relatively sophisticated contingent contracts, unlike fee or royalty schemes, would forestall the appearance of sudden profit spikes that trigger renegotiation pressures. A variety of contractual measures, from training, employment, and management participation of the LDC nationals to phased equity participation of the host would add stability.

The extensive linkages of the scheme should greatly reassure the mining company that the negotiated terms of the contract would be honored. The current loss of company bargaining power once the investment is made would be replaced by a lower renegotiation probability and surer prospects of compensation in the event of adverse action. Moreover, contingent fiscal provisions can offer protection from excessive tax burdens during downturns in metal prices. On balance, the proposal should offer a form of stability that is advantageous to all sides.

*Entry into the Scheme*

To join the scheme, mining companies must be willing to trade long-term, apparently more lucrative contracts that involve little transfer of ownership, technology, or managerial skills in exchange for more moderate returns and more stable contracts. In return for giving up their apparently cheap renegotiation option, developing countries would gain investment as well as managerial and technological skills.

Despite the general perception of LDCs that capital is scarce, one might argue that developing countries may be most reluctant to join such a scheme. It may yield too much power—"control
over internal affairs"—to outsiders. Several factors should act to mitigate this objection.

First, the ability to commit oneself convincingly is an immense advantage to anyone aspiring to enter contractual obligations. The current lack of such power is widely believed to cause economically painful withholding of capital, management, and technology from many LDCs. Some argue that it is just a matter of time until these consequences increase to overcome what is an already diminishing LDC resistance to international involvement in contractual matters. The prospect of a scheme such as the one proposed, which would attract capital and which includes many features that respect developing country sensibilities, might offer a desirable vehicle for change.

Second, the plan does not call for an acknowledged legal obligation for the host country to compensate the company for major forced changes. In fact, the obligation might be strongly felt by the host, which would presumably try hard to avoid the continuing rancor of the other union members (especially the international financial institutions) who would be liable for compensating an injured mining company. But, strictly speaking, the host would not have to agree to "international arbitration" of its internal affairs. As a practical matter, it is not at all uncommon for developing countries, including some from Latin America, to agree to make contract terms subject to the courts of other jurisdictions and to find ways around the Calvo doctrine. In the Law of the Sea negotiations, moreover, there was virtual consensus on the rules for international dispute resolution. In short, practical precedents exist for the plan.

Third, if a carefully devised procedure were used to negotiate such a system into existence, the simultaneous entrance of several LDCs into the system would make any single country’s decision to join much easier. Widespread LDC participation in the functions of the union would lend legitimacy to the undertaking. The principle of developing country unity (as demonstrated by the Group of 77 and certain regional groups in particular) has proved durable.

33 For example, Radetzki and Zorn, in Sideri and Johns, footnote 2, p. 197, suggest that increased competition for capital among LDCs may eventually reduce their bargaining power in financial negotiations.
34 Mikesell, in Sideri and Johns, footnote 2, p. 303.
A mutual insurance scheme would use the power of this principle and, at the same time, would make participation in the institution more politically palatable.

Finally, if these factors are collectively insufficient to allow such a scheme to come into being, it might be negotiated into existence as part of a broader, systemic change. Greater LDC access to capital markets, increased funds for LDC resource exploration, new commodity agreements, or a renunciation of extranational control of multinationals by their home governments might all be parts of a package that could induce the establishment of a scheme along the proposed lines.

In any case, the pure analysis of insecure contracts suggests general principles for approaching the mineral contracts problem. Sketching institutional responses to the difficulties of implementing the proposal also offers guidance for fashioning solutions to the analogous problems that arise in many other contexts.

The particular proposal is not a comprehensive solution to the problem of Third World mineral development—although it could be part of one—nor is it intended to be yet another scheme to make the world safe for one-sided capitalistic exploitation. Instead, to the extent that there are genuine joint gains in the transfer of technology and managerial skills and in the provision of risk capital, as well as in a larger and more stable supply of resources, the scheme could help these gains to be realized.

Skeptics would undoubtedly be correct in pointing to practical difficulties that the proposed scheme would encounter, as well as to its shortcomings with respect to various idealized solutions to the problem of global inequality of which resource development is but one facet. If they are right, however, and if no new sources of capital appear that reverse the current trend away from investment in the Third World, then the potential joint gainers from equitable programs of natural resource development will instead find themselves joint losers.

35 It is not necessarily true that it would be in the best interests of developing countries to obtain ownership and control by placing some of their scarce risk capital into mineral development, given its highly variable costs and revenues. And even if an LDC obtained debt or equity funding from less imperfect capital markets, it likely would only be able to claim streams of returns commensurate with its assumed risk. Use of traditional taxing power to capture any rents may be a better bet for the country. See Walde, footnote 6, p. 292.