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Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Managing Editor: Shawn Lim (shawnlwk@gmail.com)

Government-held equity in foreign investment projects: Good for host countries?

by
Louis T. Wells*

A recent *Perspective* concluded that, in countries given to sudden shifts in policy, "a host country government equity stake in a project may decrease project risk by giving the state a reason *not* to demand a renegotiation."[1] An investor may benefit, but does the host country? In my experience, rarely.

Various host governments have long insisted on equity in extractive projects. Liberia obtained 50% "free" equity in the 1953 agreement that led to the LAMCO iron ore mine, waiving income taxes in exchange. Today, many African and Asian governments demand small shares in mining projects – free or, sometimes, paid for – and likely surrender something to compensate.

Governments seek equity mainly because they expect revenue, control through board representation, political benefits or local support from communities' gaining a stake.
Yet, expected revenues are rarely forthcoming. Equity owners share dividends, not taxable profits. In addition to the usual transfer-pricing manipulations, majority owners can minimize dividends by providing much of the investment as debt (90% debt in the case of LAMCO) from affiliates, diverting cash flows to pay interest and repay principal to themselves. They can provide subsequent investment out of retained earnings, forcing the government to participate. They may even decide to lend excess cash to affiliates elsewhere instead of declaring dividends. Except for legitimate interest payments, these "costs" should not deductible for calculating taxable income, but nonetheless capture cash flow.

Tax legislation sometimes provides protection against excess interest deductions for affiliate debt (e.g., by limiting deductions to a percentage of taxable income or limiting debt/equity ratio for tax purposes) and governs transfer-pricing for purchases, management fees and marketing fees. But tax laws rarely protect minority shareholders from such abuses. Unsurprisingly, LAMCO's management fees and shipping and marketing fees to affiliates captured cash flows that were expected by government. As a result, in revenue terms, a 35% equity stake is worth much less than a 35% tax on income—something often misunderstood by governments.

Dilution is another problem. Governments rarely address what happens when new shares are issued. In order to maintain its percentage interest, government may be called on to provide funds, even if the initial equity stake was free. But government resources might be better utilized elsewhere, such as for investments that decrease national dependency on unstable commodity prices. To be sure, some agreements (e.g., ArcelorMittal's mining agreement in Liberia, as renegotiated in 2006/7) allow for dilution of government equity while protecting a minimum interest without additional government investment.

The search for control has been equally disappointing. Although a minority equity stake may carry the right to appoint directors to mining entities, majority shareholders can make important decisions before board meetings. Moreover, governments usually appoint their officials to boards. They rarely receive sufficient information in advance of meetings and lack the time, expertise and staff to evaluate proposals or raise issues. It is also not clear whether they are to represent the company's or government's interests.[2] Finally, investors can capture their loyalty through friendships, travel opportunities or even bribes.

Foreign investors often argue that government directors' votes amount to government approval. This cannot be accepted, especially since directors may not even come from the ministry with the relevant expertise or regulatory authority.

In theory, these potential problems can be managed through a carefully drafted shareholders' agreement. However, I have never seen a government conclude such a comprehensive agreement in a developing country. Even if negotiated, I have doubts that such an agreement could be properly administered.

Fortunately, government equity is not necessary. Taxes and royalties are more reliable sources of revenue. Although I think it would be a bad idea, if the presence of government-appointed directors *is* important for political reasons, governments can insist on having this right without holding equity. If a stake for local communities *is* important, this would be better achieved through royalties rather than ownership, which may backfire when communities eventually discover that their stakes yield little or nothing.

Another possibility is for a state-owned enterprise with financial expertise to hold equity as an active partner in the project, as is common for petroleum extraction. The pattern for petroleum has not been widely replicated in the mining sector.

James and Vaaler may be right to say that some government ownership can mean a more stable agreement. However, a stable agreement may not be good for the state when circumstances change (e.g., mineral prices rise) or if the original deal was negotiated with corrupt or incompetent officials. BITs and FTAs should provide more than enough protection for investors.

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[*] Louis Wells (lwells@hbs.harvard.edu) is Herbert F. Johnson Professor of International Management, Emeritus, Harvard Business School. The author would like to thank Joseph Bell, Natty Davis, James Otto, and Perrine Toledano for their helpful peer reviews. **The views expressed by the author of this**

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[1] Barclay James and Paul Vaaler, "Minority rules: State ownership and foreign direct investment risk mitigation strategy," *Columbia FDI Perspectives*, No. 111, December 23, 2013.

[2] James and Vaaler assume they represent the company. If that is true, they are unlikely to protect state interests.

For further information, including information regarding submission to the *Perspectives*, please contact: Vale Columbia Center on Sustainable International Investment, Shawn Lim, shawnlwk@gmail.com or shawn.lim@law.columbia.edu.

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