WHEN STATES INVEST AT HOME: THE DEVELOPMENT ROLE OF SOVEREIGN WEALTH FUNDS IN PUBLIC FINANCE

Patrick J. Schena[*]

INTRODUCTION

In August 2016, Turkey announced details of a plan to establish a sovereign wealth fund ("SWF")—the Turkey Wealth Fund.[1] The basic organizational design of the fund was presented and, in early 2017, shares of Turkish state-owned enterprises ("SOEs") were transferred to the fund and dividends were diverted to the fund from the central budget.[2] While the precise operating framework and plan for the fund are still under review, indications from the government suggest that the fund will leverage holdings of state enterprises to borrow in global capital markets.[3] This format is certainly not unusual among SWFs organized as state holding companies.[4] More unusual is the prospect that the funds will be used for investment in capital and infrastructure projects *in Turkey*.[5] In fact, such an operating model may indeed call into

* Patrick Schena, PhD, is Adjunct Assistant Professor of International Business Relations at the Fletcher School, Tufts University, and Co-Head of SovereigNET: The Fletcher Network for Sovereign Wealth and Global Capital.

1. Ercan Ersoy & Firat Kozok, *Turkey Unveils Draft Details of Planned Sovereign Wealth Fund*, BLOOMBERG (Aug. 2, 2016, 5:45 AM), https://www.bloomberg.com/news/articles/2016-08-02/turkey-unveils-draft-details-of-planned-sovereign-wealth-fund.

2. Orhan Coskum, *Turkey Transfers Billions In Major Company Stakes to Sovereign Wealth Fund*, REUTERS (Feb. 6, 2017, 10:16 AM), http://www.reuters.com/article/us-turkey-economy-fund-idUSKBN15L1PG; Ersoy & Kozok, *supra* note 1.

3. *See* Elif Binici, *Turkey's Sovereign Wealth Fund Set to be Ambitious Player in Capital Markets*, DAILY SABAH (Mar. 5, 2017), https://www.dailysabah.com/economy/2017/03/06/turkeys-sovereign-wealth-fund-set-to-be-ambitious-player-in-capital-markets; Ersoy & Kozok, *supra* note 1 (listing the potential sources of the fund's financing).

4. *See, e.g.*, Fabio Bertoni & Stefano Lugo, The Use of Debt by Sovereign Wealth Funds (Sept. 4, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2656228.

5. Coskum, *supra* note 2 (noting that the political uncertainty and insecurity in Turkey led people to believe that investment in domestic infrastructure was not a strong possibility).

question whether Turkey is actually setting up a SWF.[6] SWFs arrived into international financial consciousness prior to the global financial crisis in 2007.[7] Punctuated by rising commodity prices and expanding reserves, their growth trajectory led to expectations of steadily accumulating assets as well as increasing influence in international capital markets.[8] As the crisis deepened and global liquidity drained from the system, SWFs—awash in cash—even provided timely equity capital to a number of global financial institutions.[9] Since then, the pace of SWFs' asset growth has

6. The challenge to institutional identification is that, as conduits between global capital markets and the domestic economy, the mandates of such "leveraged" funds are similar to those of development banks. Can Sezer, *Turkish Wealth Fund More Akin to National Development Bank: S&P*, REUTERS (Feb. 10, 2017), http://www.reuters.com/article/us-turkey-economy-fund-s-p-idUSKBN15P0ZW. A key distinction is that, unlike a development bank, the fund, as owner, is also—ostensibly—responsible for the management and disposition of its assets, including holdings of state- or government-linked companies. Jonathan Brookfield, Ravi Shankar Chaturvedi & Patrick Schena, *Sovereign Wealth Funds and the Privatizaiton of State Assets: Toward a Life-cycle Framework*, *in* BRAVING THE NEW WORLD: SOVEREIGN WEALTH FUND INVESTMENT IN THE UNCERTAIN TIMES OF 2010, MONITOR GRP. 38, 41 (2011), http://www.baffi.unibocconi.it/wps/allegatiCTP/SWF_AnnualReport2010_1.pdf.

7. Surendranath R. Jory et al., *The Role of Sovereign Wealth Funds in Global Financial Intermediation*, 52 THUNDERBIRD INT'L BUS. REV. 589, 591 (2010).

8. The literature on SWFs prior to the global financial crisis is extensive and heavily dominated by concerns that rapid accumulations of institutional wealth could be destabilizing to the international financial system, particularly when controlled by states and managed opaquely. *See generally* DIANA FARRELL ET AL., MCKINSEY GLOB. INST., THE NEW POWERBROKERS: HOW OIL, ASIA, HEDGE FUNDS, AND PRIVATE EQUITY ARE SHAPING GLOBAL CAPITAL MARKETS (Oct. 2007), http://www.mckinsey.com/global-themes/employment-and-growth/how-the-new-power-brokers-are-shaping-global-capital-markets (presenting an early study from that period summarizing key issues).

9. Jory et al., *supra* note 7, at 592.

plateaued,[10] largely due to the precipitous drop in oil prices[11] and slower reserve accumulation.[12]

SWFs, as institutions, have become more widely recognized and accepted as professional investors and co-investment partners.[13] Since the global financial crisis, their institutional remit has likewise evolved, as indicated by the case of Turkey.[14] Yet Turkey is far from alone. A wide number of states—many with emerging economies—have discussed, proposed, announced, or launched a fund.[15] These include Poland, Romania, Kenya, Egypt, Israel, Armenia, India, Indonesia, Thailand, Bangladesh, and Guyana.[16] In several instances (e.g., Kenya, Egypt, Israel, and Guyana), consideration of a fund is linked to anticipated revenue streams from newly discovered oil and gas deposits.[17] In others, such as Turkey, the objective is discretely development focused.[18]

This Article will examine this contemporary reality: SWFs are being established at an accelerated rate with mandates—in whole or part—focused on development, diversification, and economic transformation. The objective is to peer into the future of these

---

10. *Sovereign Wealth Fund Rankings*, SWFI, http://www.swfinstitute.org/sovereign-wealth-fund-rankings/ (last visited Oct. 28, 2017).

11. Oil prices declined from $114 per barrel to $30 per barrel between June 2014 and January 2016, which led to nearly $200 billion being withdrawn from the assets of selected SWFs (e.g., the Saudi Arabian Monetary Authority and the Russia Reserve Fund). For the Saudi Arabian Monetary Authority, see *Monthly Statistics*, SAUDI ARABIAN MONETARY AUTHORITY, http://www.sama.gov.sa/en-US/EconomicReports/Pages/MonthlyStatistics.aspx (last visited Oct. 28, 2017). For the Russia Reserve Fund, see *Reserve Fund Statistics*, MINISTRY OF FINANACE OF THE RUSSIAN FEDERATION, http://old.minfin.ru/en/reservefund/statistics/ (last visited Sept. 15, 2017). For the Russia National Wealth Fund, see *National Wealth Fund Statistics*, MINISTRY FIN. RUSSIAN FED'N, http://old.minfin.ru/en/nationalwealthfund/statistics/ (last visited Oct. 28, 2017). Calculations are based on author-compiled data as reported by official sources. *See Sovereign Wealth Fund Rankings*, *supra* note 10.

12. *See, e.g.*, Jack Malvey et al., *Central Bank Foreign Exchange Reserve Accumulation Slows*, BNY MELLON (Feb. 2015), https://www.bnymellon.com/emea/en/our-thinking/central-bank-foreign-exchange-reserve-accumulation-slows.jsp (showing rates of reverse accumulation).

13. INT'L WORKING GRP. OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES: "SANTIAGO PRINCIPLES" 1 (2008) [hereinafter SANTIAGO PRINCIPLES], http://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf.

14. *See* Ersoy & Kozok, *supra* note 1 (noting that Turkey is moving forward with establishing an SWF despite the turmoil the country has faced).

15. *See* Patrick J. Schena, Juergen Braunstein & Asim Ali, Capitalizing Economic Development Through Sovereign Investment: The Paradox of Capital? 10 (Apr. 28, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2962509 (discussing the creation of various funds).

16. *Id.*

17. *Id.* at 9.

18. *Id.* at 4.

funds and frame the rationale for SWFs as domestic investors in development to direct or catalyze investment as professionally managed and governed investment institutions. Part I of the Article—like most articles on SWFs—covers definitional matters. Relieved of this burden, Part II examines the role and structure of existing funds with development or strategic investment mandates. Parts III and IV outline an economic rationale for an active role for SWFs in development derived from contemporary frameworks offered by "new structural economics" and the research of Mariana Mazzucato on the so-called "entrepreneurial state." Part III focuses on the role of the state in the design and execution of economic development policy, while Part IV examines institutional barriers that may inhibit flows of foreign capital to augment the state's resources available for investment in national development. Part V aims to identify and analyze features of fund organization and governance, including those in practice, that are designed to overcome government failures in the public investment process and enhance the overall level of institutional quality.

I. WHAT'S IN A NAME?

The term "sovereign wealth fund" is widely attributed to Andrew Rosanov, during his tenure at State Street in 2005.[19] This terminology followed long after the creation of the earliest of SWFs in the contemporary period, thought to be the Kuwait Investment Office in 1953.[20] Today, SWFs are a broadly diverse and heterogeneous cohort of institutions that have become most commonly defined or grouped "by the beholder."[21] Definitions are often carefully crafted for a particular purpose and taxonomies are based upon many criteria, including geography, source of capitalization, mandate, and—most frequently—purpose. A practical means by which to establish a common perspective regarding these institutions is via a baseline. This method is undertaken intentionally to capture the amorphous nature of the term "sovereign wealth fund." Thus, this Article posits that a SWF is a portfolio of state assets, not bound by institutional form, that is invested on behalf of a state owner by an investment manager appointed by the owner. This baseline does not discriminate as to the type or source of the assets, the legal status of the fund, the

---

19. WHARTON LEADERSHIP CTR., THE BRAVE NEW WORLD OF SOVEREIGN WEALTH FUNDS 1, 8 (2010), http://d1c25a6gwz7q5e.cloudfront.net/papers/download/052810_Lauder_Sovereign_Wealth_Fund_report_2010.pdf.

20. *Id.* at 11.

21. For a review of the definitional challenges related to SWFs, see generally Javier Capapé & Tomás Guerrero, *More Layers Than an Onion: Looking for a Definition of Sovereign Wealth Funds*, (ESADE Bus. Sch., Research Paper No. 21, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2391165.

markets in which the assets are invested, or any other criterion. With respect to purpose, SWFs are most commonly associated with stabilization mandates that seek to insulate economies from volatile revenue flows or savings mandates that are designed for wealth preservation and transfer for the benefit of future generations.[22] An extension of the savings mandate includes those related specifically to pension reserve management—i.e., a savings function specifically to fund future pension liabilities[23]—such as the New Zealand Superannuation Fund[24] and the Australia Future Fund.[25] It is also certainly not uncommon for funds to have multiple defined purposes or for the purpose of the fund to change over time due to growth (Norway's Government Pension Fund Global),[26] contraction (Ireland's National Pensions Reserve Fund),[27] or even a change in the nature of its holdings (Singapore's Temasek).[28]

Traditionally, a small number of funds fit neither the stabilization nor savings paradigm. These funds, in fact, are among the oldest of contemporary structures, often organized under local corporation law as state holding companies and capitalized by transfers of SOEs,[29] not unlike the Turkey Wealth Fund described above. Such funds are also active borrowers in international capital markets and leverage global markets to raise capital to support portfolio companies and finance operations.[30] Their primary purpose is to strategically manage, finance, and privatize SOEs and also to invest in large-scale domestic projects in a national development capacity.[31] Temasek might be one such example.[32]

---

22. *See* Eliot Kalter & Patrick J. Schena, *The Role of Emerging Markets' Sovereign Wealth Funds*, *in* INVESTING IN EMERGING AND FRONTIER MARKETS 17, 18–19 (Kamar Jaffer ed., 2013) (discussing the different purposes that SWFs may have in different countries).

23. *Id.*

24. *Purpose and Mandate*, NZ SUPER FUND, https://www.nzsuperfund.co.nz/nz-super-fund-explained/purpose-and-mandate (last visited Oct. 28, 2017).

25. *About Us*, FUTUREFUND: AUSTL.'S SOVEREIGN WEALTH FUND, http://www.futurefund.gov.au/about-us (last visited Oct. 28, 2017).

26. *See, e..g.*, Nor. Ministry of Fin., *The Government Pension Fund*, GOVERNMENT.NO, https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/id1441/# (last visited Oct. 28, 2017).

27. *See, e.g.*, *National Pensions Reserve Fund*, SWFI, http://www.swfinstitute.org/swfs/national-pensions-reserve-fund/ (last visited Oct. 28, 2017).

28. *See, e.g.*, *Portfolio Highlights: Sector*, TEMASEK (Mar. 31, 2017), http://www.temasek.com.sg/portfolio/portfolio_highlights/sector.

29. *See* Schena, Braunstein & Ali, *supra* note 15, at 7–8.

30. *Id.*

31. *Id.*

32. *Id.* In the 1970s, Singapore merged assets into a holding company—Temasek—which was expected to increase efficiency while also serving as a financing conduit for portfolio companies through the issuance of bonds in the global markets; Temasek does not refer to itself as a SWF. *About Temasek*, TEMASEK, http://www.temasek.com.sg/abouttemasek (last visited Oct.

The term "sovereign development fund" ("SDF") was first used by Eric Parrado to described these institutions.[33] The phrase was then used again by Javier Santiso in 2008.[34] By 2010, "sovereign development fund" entered formally into the SWF lexicon when the International Monetary Fund began to use it in its typology of SWF mandates.[35] Das et. al described SDFs as investment institutions that "typically help fund socioeconomic projects or promote industrial policies that might raise a country's potential output growth."[36]

II. SOVEREIGN DEVELOPMENT AND STRATEGIC INVESTMENT FUNDS

The landscape of public investment is expansive and encompasses a variety of forms. These forms range from direct budgetary allocations for capital investment through national and subnational ministries,[37] to directed or concessionary lending to projects and sectors,[38] and even to investments in seed venture capital and private equity funds.[39] This Article conceptualizes channels of public investment along a continuum from debt to equity.[40] At the debt pole, development banks have principally

---

28, 2017). Temasek is also not a member of the International Forum of Sovereign Wealth Funds and so was not captured under the definition of "sovereign wealth fund" in the proposed Trans-Pacific Partnership. *See* Trans-Pacific Partnership, ch. 17, at 17-3, Feb. 4, 2016, https://ustr.gov/sites/default/files/TPP-Final-Text-State-Owned-Enterprises-and-Designated-Monopolies.pdf. Its recognition functionally as a SWF with domestic effect was, however, captured in the Trans-Pacific Partnership via an exception footnote in chapter 17. *Id.* at 17-31 n.37.

33. *See* Javier Santiso, Sovereign Development Funds: Key Financial Actors in the Shifting Wealth of Nations 11 (Oct. 2008) (unpublished manuscript), http://www.oecd.org/dev/41944381.pdf.

34. *Id.* at 2.

35. Udaibir S. Das et al., *Setting Up a Sovereign Wealth Fund: Some Policy and Operational Considerations* 9 (IMF, Working Paper No. 09/179, 2009), http://www.imf.org/external/pubs/ft/wp/2009/wp09179.pdf.

36. UDAIBIR S. DAS ET AL., ECONOMICS OF SOVEREIGN WEALTH FUNDS: ISSUES FOR POLICYMAKERS 60 (2010).

37. *See, e.g.*, GEORG INDERST & FIONA STEWART, WORLD BANK GRP., INSTITUTIONAL INVESTMENT IN INFRASTRUCTURE IN EMERGING AND DEVELOPMENT ECONOMIES 4 (2014), http://documents.worldbank.org/curated/en/748551468337163636/Institutional-investment-in-infrastructure-in-emerging-markets-and-developing-economies.

38. *See, e.g.*, GILBERTO M. LLANTO ET AL., DIRECTED CREDIT PROGRAMS: ISSUES AND FRAMEWORK FOR REFORM 6 (1999), http://pdf.usaid.gov/pdf_docs/Pnadi976.pdf.

39. A noted example is the case of Shenzhen Capital. *See About Us*, SHENZHEN CAP. GRP. CO., LTD., http://www.szvc.com.cn/english/AboutUs/Introduction/index.shtml (last visited Oct. 28, 2017).

40. All but a cursory discussion of this landscape is beyond the scope of this analysis. For a more detailed review of institutional forms for public investment, see generally Patrick J. Schena & Asim Ali, *State Investment in Economic Transformation: Toward a Sovereign Institutional Framework*,

served as lending institutions, bridging underdeveloped local markets for long-term debt by augmenting their capital base using debt issuances in global markets for on-lending to domestic projects.[41] At the equity pole, venture capital seed funds direct funding to domestic general partners to provide long-term risk capital to small- and medium-size enterprises and to build local private equity capacity.[42] In some markets, such as China, state-owned private equity limited partnerships directly fund new business and innovation while also building local market private investment capacity.[43]

Between the poles, a variety of state investment structures also exist to channel public capital—both debt and equity—into domestic economies. State capital corporations, sometimes established as finance subsidiaries of a state holding company, provide banking, advisory, and investment services to finance strategic projects.[44] State investment holding companies, such as Mumtalakat in Bahrain, engage in asset management, monitoring, and operational support for state-invested firms and also facilitate privatizations.[45] Like development banks, many of these companies borrow in global debt markets and on-lend to portfolio companies, serving in some

WORLD ECON. J., (Jan.–Mar. 2017), http://www.world-economics-journal.com /ArticleDetails.details?AID=662.

41. An example might be the European Investment Fund, a subsidiary of the European Investment Bank, which functions as a fund of funds. *See* EUROPEAN INV. FUND, http://www.eif.org/ (last visited Oct. 28, 2017).

42. A noted example of state intervention to promote indigenous private equity markets is Taiwan, Republic of China. *See generally* Christopher John Gulinello, *Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience*, 37 GEO. WASH. INT'L. L. REV. 845 (2005). The government, through a variety of financial and tax incentives, along with indirect participation by the Ministry of Finance, incubated the development of local markets for venture capital. *See id.* at 855–57. A specific instance is the author's own experience with an innovative fund, the Golden Gate Investment Fund, managed by a U.S. technology information technology multinational as general partner, in which the Republic of China's Ministry of Finance invested as limited partner. The Ministry of Finance was motivated by the need to promote a local venture capital market and to access technology-based foreign investment and foreign markets for Taiwan's value-added technology products. Patrick J. Schena, *Financing the Expansion of Global Energy: The Role of SWF Investment as Strategic Private, in* SOVEREIGN WEALTH FUNDS 2013, at 77, 82 n.19 (2013), http://fletcher.tufts.edu/~/media /Fletcher/Microsites/swfi/pdfs/SCHENA_FinancingExpansionGlobalEnergy.pdf. Its participation and "guidance" led over twenty of the largest Taiwanese corporations to participate in the fund as limited partners. *Id.*

43. A noted example is Shenzhen Capital, established in China in 1999 by the Shenzhen government as a limited venture capital company. *See About Us*, *supra* note 39.

44. *See, e.g.*, *About DIC*, DUBAI INTE'L CAP., http://www.dubaiic.com (last visited Oct. 28, 2017).

45. *See, e.g.*, *Mumtalakat: Investing for Bahrain*, BAHR. MUMTALAKAT HOLDING COMPANY, http://www.bmhc.bh/ (last visited Oct. 28, 2017).

respects as an internal capital market.[46] Not least, sovereign investment funds with domestic mandates invest surplus state capital to finance key initiatives of the state and catalyze foreign investment into domestic projects with specific socioeconomic policy objectives.[47]

The focus here is on the latter two—the subset of SWFs commonly referred to as SDFs or strategic investment funds ("SIFs").[48] These funds can be organized by capitalization and mandate along three primary dimensions. Traditional SDFs—such as Temasek, Malaysia's Khazanah, Mumtalakat, and Kazakhstan's Samruk-Kazyna—as noted, are capitalized by state-operated assets and generally have mandates to manage, privatize, and build.[49] Infrastructure or, more broadly, policy funds—such as the infrastructure subfund of the Nigeria Sovereign Investment Authority—have a discrete mandate to invest in domestic projects with a policy theme, e.g., infrastructure.[50] SIFs—such as Italy's CDP Equity, the Ireland Strategic Investment Fund, and the Russia Direct Investment Fund—invest in strategic sectors of the domestic economy as minority investors, catalyzing both private and foreign investors.[51] Emergent funds typically adopt one or a hybrid of such forms.[52]

The broad cohort of SDFs shares an inward investment orientation in part because of the nature of their fund holdings (e.g., SOEs).[53] However, little consensus exists on the nature of the

46. Patrick J. Schena & Ravi Shankar Chaturvedi, Sovereign Wealth Funds, Debt Issuances, and the Development of Capital Markets 2 (Nov. 2011) (unpublished manuscript), http://fletcher.tufts.edu/~/media/Fletcher/Microsites/swfi/pdfs/Nov11SchenaChaturvediSWFBondIssuances.pdf.

47. *See* Schena, Braunstein & Ali, *supra* note 15, at 5.

48. *See generally* Santiso, *supra* note 33 (discussing the subset of SWFs that are referred to as "sovereign development funds").

49. *See* Håvard Halland et al., *Strategic Investment Funds: Opportunities and Challenges* 3 (World Bank Grp., Fin. & Markets Global Prac. Grp., Policy Research Working Paper No. 7851, 2016), http://documents.worldbank.org/curated/en/235311475681523659/pdf/WPS7851.pdf.

50. *See, e.g.*, *Nigeria Infrastructure Fund*, NIGERIA SOVEREIGN INV. AUTHORITY, http://nsia.com.ng/nigeria-infrastructure-fund/ (last visited Oct. 28, 2017).

51. *See, e.g.*, *Ansaldo Energia*, CDP EQUITY, http://en.cdpequity.it/Portfolio/Investments/Ansaldo-Energia.kl (last visited Oct. 28, 2017); *How We Invest*, IR. STRATEGIC INV. FUND, http://isif.ie/how-we-invest/ (last visited Oct. 28, 2017); *Portfolio*, RUSSIAN DIRECT INV. FUND, https://rdif.ru/Eng_Portfolio/ (last visited Oct. 28, 2017).

52. *See* Orhan Coskun, *Turkey Dismisses Head of $40 Billion Wealth Fund After Slow Start*, REUTERS, https://www.reuters.com/article/us-turkey-economy-fund/turkey-dismisses-head-of-40-billion-wealth-fund-after-slow-start-idUSKCN1BJ108 (Sept. 8, 2017); Richard Milne, *Norwegian Sovereign Wealth Fund Unviels Radical Investment Changes*, FIN. TIMES, https://www.ft.com/content/37d0afd0-9c27-3b19-a676-10192126af1e?mhq5j=e7 (Sept. 4, 2017).

53. *See* Schena & Ali, *supra* note 40.

operating model of a SDF and, in particular, what distinguishes it from a SWF more generally.[54] Dixon and Monk focus on the role that SDFs can play in enhancing productive efficiency and, through their investment programs, in supporting economic diversification and a deepening of local financial market capacity.[55] Clark and Monk contrast SWFs and SDFs more directly and suggest that SWFs generally pursue a fund objective of wealth appreciation, while SDFs focus on wealth creation by catalyzing or crowding-in investment in new enterprises or projects.[56] These scholars see in top-performing SDFs the features, operating practices, and capacity of venture capital and private equity investors that utilize proprietary networks and knowledge of local markets and sectors to generate excess financial returns.[57]

In some respects, the line between SDFs and SIFs is even more obscure. According to a definition offered by the World Bank, the latter are a discrete form of a special-purpose investment fund that are: (1) sponsored and/or fully or partly capitalized by a government, several governments, or government-owned global or regional finance institutions; (2) invested to achieve financial as well as economic returns, through a "double bottom line" mandate; (3) operated by expert investors on behalf of their sponsors; and (4) providers of long-term patient capital primarily as equity, but not exclusively.[58] SIFs may be capitalized using balance-of-payment surpluses, foreign currency reserves, proceeds of privatization, and receipts from commodity exports.[59] These funds may also receive capital contributions from international finance institutions and private sector actors.[60] CDP-Equity, for example, is organized to receive contributions from both public- and private-sector investors.[61] Finally, under certain circumstances, sponsors can borrow in capital markets and arbitrage the debt proceeds by on-lending or investing in the SIF.[62]

---

54. *See generally* Santiso, *supra* note 33 (discussing how the growth of SWFs may cause them to become major actors of development finance, in which case the SWFs would become "Sovereign Development Funds").

55. *See* Adam D. Dixon & Ashby H.B. Monk, *Financializing Development: Toward a Sympathetic Critique of Sovereign Development Funds*, 4 J. SUSTAINABLE FIN. & INV. 357, 357–71 (2014).

56. Peter B. Clark & Ashby H.B. Monk, Sovereign Development Funds: Designing High-Performance, Strategic Investment Institutions 8 (Sept. 30, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2667974.

57. *Id.* at 9.

58. Halland et al., *supra* note 49, at 2–3.

59. *Id.* at 5.

60. *Id.* at 27.

61. *About Us*, CDP EQUITY, http://en.cdpequity.it/what-we-do/ (last visited Sept. 16, 2017).

62. Halland et al., *supra* note 49, at 20.

Through 2014, some twenty funds had been established with mandates to invest domestically.[63] By 2015, the pace of growth of development funds and SIFs increased such that, in the last two years, the number of funds with exclusively domestic or hybrid mandates has expanded dramatically.[64] Moreover, whereas SWFs were originally created from surplus wealth or an abundance of state assets, many new funds are being proposed and established without a surplus of liquid or real assets and, instead, are launched specifically to directly catalyze the inward flow of foreign direct investment as a long-term, relatively stable form of risk capital.[65] What has prompted this acceleration?

SWFs, in the broadest sense, are institutional structures of public finance designed to manage financial and real assets owned by the state. As such, the motivation to establish a SWF has traditionally been "supply-driven," established in response to or in anticipation of the accumulation of assets.[66] Countries with domestic economies that are plagued by poor physical and commercial infrastructure with low economic absorptive capacity and underdeveloped industrial or commercial sectors have, in fact, been discouraged from using capital surpluses for domestic investment, especially if extra budgetary.[67] Very real risks of macroeconomic distortions and concerns about the quality of public investments have supported this premise,[68] especially amongst resource economies that experience windfalls of new revenues that cannot be absorbed by the domestic economy without adverse consequences for other sectors.[69]

In recent years, however, the collapse in global commodity prices, declining resource revenues, slowing of economic growth and global trade and investment, and reductions in traditional sources of long-term finance[70] have prompted governments to challenge the efficacy of investing surplus wealth in foreign markets when capital constraints inhibit investment in physical and commercial

---

63. *Id.* at 24.

64. *See id.*

65. Schena, Braunstein & Ali, *supra* note 15, at 2.

66. *Id.*

67. Alan Gelb et al., *Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities* 2 (World Bank, Poverty Reduction & Econ. Mgmt. Network, Pub. Sector Governance Unit & Sustainable Dev. Network, Oil, Gas & Mining Unit, Policy Research Working Paper No. 6776, 2014), http://documents.worldbank.org/curated/en/788391468155724377/pdf/WPS6776.pdf.

68. *Id.*

69. Frederick van der Ploeg & Anthony J. Venables, *Absorbing a Windfall of Foreign Exchange: Dutch Disease Dynamics* 103 J. DEV. ECON. 229, 229–30 (2013). This condition is commonly referred to as "Dutch Disease." *Id.*

70. Gelb et al., *supra* note 67, at 2.

infrastructure domestically.[71] The World Bank Group ("WBG"), in particular, has acknowledged this "shift of emphasis"[72] and further suggests that, if on a relative return basis domestic risk-adjusted returns on projects exceed those on foreign assets, an optimal strategy might be to increase domestic investment versus accumulating long-term foreign assets.[73] However, surpluses notwithstanding, many new development or strategic fund mandates are being proposed and launched in economies that, in fact, have not enjoyed sizeable surpluses but nonetheless have development or infrastructure investment needs (i.e., a demand for such investments).[74] In many cases, the WBG has undertaken initiatives to provide advice and services to mitigate externalities resulting from domestic investment by SWFs and to enhance domestic institution building.[75] These efforts will contribute to, and perhaps further accelerate, the launch of new funds with similar mandates.

The following two Parts of this Article will explore the economic rationale for this evolution by focusing on the institutional role of the state in economic development. Part III reviews contemporary economic arguments concerning the degree of direct and active engagement by the state in national development. Part IV focuses on the role of foreign capital and barriers to capital flows that result specifically from low levels of institutional quality.

III. NEW STRUCTURAL ECONOMICS VS. THE STATE AS "ENTREPRENEUR"

The role of industrial policy in national development is frequently linked to the rise of the developmental state—in particular its Asian expression.[76] Active state participation in the

---

71. *Id.*

72. Halland et al., *supra* note 49, at 24.

73. *See generally id.* (discussing the optimal strategy of investing domestically to create greater returns than would be achieved via foreign investing).

74. Schena, Braunstein & Ali, *supra* note 15, at 15–16.

75. For example, the World Bank established the Investment Funds for Development Group in 2015 "to enable emerging markets and developing countries to establish appropriate conditions for mobilizing investment funds' resources for small and medium enterprises (SMEs), infrastructure, and climate mitigation and adaption finance." *Investment Funds*, WORLD BANK (Dec. 16, 2015), http://www.worldbank.org/en/topic/financialsector/brief/investment-funds.

76. A detailed discussion of either the intellectual roots or industrial policy or the Asian development model are beyond the scope of this paper. *See generally* ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989); THE DEVELOPMENTAL STATE (Meredith Woo-Cumings ed., 1999); CHALMERS JOHNSON, MITI AND THE JAPANESE MIRACLE (1982); EZRA F. VOGEL, THE FOUR LITTLE DRAGONS: THE SPREAD OF INDUSTRIALIZATION IN EAST

economy, from policy coordination to direct investment, systematically expanded the technological and industrial base of many rapidly growing Asian economies.[77] Commercial sectors became laden with SOEs, as government technocrats guided a capitalist model with the state entrenched at the core.[78] Financial systems evolved to be heavily bank-centric, supplemented by government-owned development banks that bridged local and global markets for long-term capital.[79] The roots of development funds—for example in Singapore (Temasek) and Malaysia (Khazanah)—also reside in this legacy.[80] State intervention, whether in product or financial markets, was rationalized by the pervasiveness of market failures that inhibited the efficient allocation of resources and capital.[81]

The persistence of a state role in national economies inspired reconsideration of earlier approaches to structural economic transformation. This work—linked to Jason Lin during his tenure as the WBG's chief economist—begins with the premise that developing economies are indeed inherently plagued by a variety of market failures that are beyond the ability of individual market participants to resolve.[82] This condition includes failures resulting from information asymmetries and challenges in the design, sequencing, coordination, and execution programs to enhance core

---

ASIA (1991); ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION (1990).

77. *See generally* HA-JOON CHANG, THE EAST ASIAN DEVELOPMENT EXPERIENCE: THE MIRACLE, THE CRISIS, AND THE FUTURE 13–54 (2006) (discussing the east Asian model of economic policy, including overall investment policy, industrial policy, and trade policy).

78. Kellee S. Tsai & Barry Naughton, *Introduction* to COMPARATIVE PERSPECTIVES IN BUSINESS HISTORY 1, 3 (Cambridge Univ. Press 2015).

79. *See* OECD, THE ROLE OF BANKS, EQUITY MARKETS AND INSTITUTIONAL INVESTORS IN LONG–TERM FINANCING FOR GROWTH AND DEVELOPMENT: REPORT FOR G20 LEADERS (Feb. 2013), http://www.oecd.org/finance/private-pensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf.

80. *See AFG Up 12% Since Temasek Pared Stake in Chinese Banks*, EDGE (July 8, 2011, 6:11 AM), http://www.theedgemarkets.com/article/afg-12-temasek-pared-stake-chinese-banks; *Temasek Trims Stake in ICBC, Says Remains Confident in Chinese Banks*, CNBC (May 19, 2017, 10:39 AM), http://www.cnbc.com/2017/05/19/temasek-trims-stake-in-icbc-says-remains-confident-in-chinese-banks.html. The link between what in contemporary parlance is referred to as state capitalism and SWFs might be attributed to Ian Bremmer, who defined state capitalism in 2009 as "a system in which the state functions as the leading economic actor and uses markets primarily for political gain." Ian Bremmer, *State Capitalism Comes of Age: The End of the Free Market?*, FOREIGN AFF. (May/June 2009), https://www.foreignaffairs.com/articles/united-states/2009-05-01/state-capitalism-comes-age. For Bremmer, SWFs are key tools of the state that seek to maximize both economic *and* political returns. *Id.*

81. *See* Bremmer, *supra* note 80.

82. JASON YIFU LIN, NEW STRUCTURAL ECONOMICS: A FRAMEWORK FOR RETHINKING DEVELOPMENT AND POLICY, at ix, 3 (2012).

institutional and physical infrastructure, including in education, finance, and legal and regulatory structures.[83] While these gaps may justify government intervention, they also make imperative that government actions themselves must not accentuate or otherwise introduce new failures.

Referred to as "new structural economics" ("NSE"),[84] this approach is grounded in the basic notion of the *complementary roles* of market and state in fostering economic development.[85] NSE assigns to the market the fundamental role of resource allocator.[86] The state's or government's role is to *facilitate* the effective participation of the private sector in the economy by coordinating investments to enhance productivity and diversification and, similarly, by mitigating the negative impacts of externalities generated in the development process.[87] A key function of the state is to encourage firm and sector development consistent with the economy's commercial and factor endowments,[88] including existing sector "clusters" within the economy that foster domestic competition and enhance productivity.[89]

The NSE framework is compatible with the reemergence of industrial policy as a tool of economic development, especially to address market failures in early stages of development.[90] This "new industrial policy," as it has been termed, is also rooted in the market failure hypothesis but stresses tight alignment with the capacity and capabilities of government, its ability to adapt to transitional changes in the economy resulting from policy implementation,[91] and the regular review and reassessment of policy. The objective is to detect and rectify institutional failures, including those that result in exploitation of the policy through capture by local special interests.[92]

NSE also aligns with institutional perspectives on national competitiveness offered by Michael Porter. Porter's "diamond model,"[93] for example, is a classic paradigm proposed to analyze

---

83. *Id.* at 30, 240, 352.

84. *Id.* at ix.

85. *Id.* at 61.

86. *Id.* at 5.

87. *Id.* at 3.

88. *See id.* at 267, 289.

89. *See id.* at 69. Clusters are the key construct advanced by Michael Porter, described in further detail below. *See infra* notes 99–102 and accompanying text.

90. *See* LIN, *supra* note 82, at 113–39.

91. Joseph E. Stiglitz, *Industrial Policy, Learning, and Development* 1, 3 (WIDER, Working Paper No. 2015/149, 2015), https://www.wider.unu.edu/publication/industrial-policy-learning-and-development.

92. *Id.* at 1.

93. Michael E. Porter, *The Competitive Advantage of Nations*, HARV. BUS. REV. (Mar.-Apr. 1990), https://hbr.org/1990/03/the-competitive-advantage-of-nations.

national competitive advantage. The model consists of four discrete determinants: (1) firm strategy, structure, and rivalry; (2) factor conditions; (3) demand conditions; and (4) related and supporting industries.[94] In this integrated system, government is not a determinant but rather serves multiple—sometimes overlapping—critical functions as an influencer, challenger, and catalyst to foster and enhance underlying determinants of national competitive advantage.[95] Governments perform such functions directly and indirectly through a variety of national and subnational structures and institutions.[96] These functions include traditional services—such as planning, promoting education and skill-building, establishing legal protections and regulatory controls, and insuring sufficient infrastructure to support economic development.[97] In particular, these efforts define the rules of competitive commerce to foster productivity growth and innovation.[98]

Key building blocks in Porter's model are "clusters"—sector-concentrated, geographic networks of companies and associated public or private institutions that provide specialized training, education, research, and forms of technical support.[99] Clusters arise dynamically as an alternative mode of commercial organization and, for Porter, are central to deepening the ability of domestic firms to compete effectively.[100] Clusters also facilitate de facto cooperation through proximity, networking, and effective vertical integration.[101] As such, these networks promote productivity growth among members, inform the direction and pace of innovation from within the cluster or beyond, and encourage new business formation. Government's role is to promote cluster formation and development and, except in cases early in the development process, this role is indirect, not involving the government directly in execution beyond insuring the sufficiency of public goods and services that allow clusters to function effectively.[102]

NSE and Porter both advance the theoretical basis for a critical economic role for the state.[103] However, each view that role as limited to solely addressing market failures.[104] Mazzucato would

---

94. *Id.*
95. *Id.*
96. *Id.*
97. *See id.*
98. *See id.*
99. Michael E. Porter, *Clusters and the New Economics of Competition*, HARV. BUS. REV. (Nov.-Dec. 1998), https://hbr.org/1998/11/clusters-and-the-new-economics-of-competition.
100. *Id.*
101. *Id.*
102. *Id.*; Porter, *supra* note 93.
103. *Compare* LIN, *supra* note 82, at 30, *with* Porter, *supra* note 93, at 86.
104. *Compare*, LIN, *supra* note 82, at 37–38, *with* Porter, *supra* note 93, at 86–88 (describing the limited role of government as one that must take certain

describe this function as essentially "de-risking" the private sector, rather than taking an active role to create or influence markets, and argues that it relegates the role of the state to resolving inefficiencies in resource allocation.[105] Instead, Mazzucato proposes that the state take a *lead role* in economic planning and execution, including as financial lead in a mission-oriented investment program that is both catalytic and transformative.[106] Moreover, she views market failures as "necessary but not sufficient condition[s] for governmental intervention" and proposes a much broader—in fact, active—role for government, provided the discrete benefits of intervention exceed any costs that result from government failures.[107] These include externalities, such as those related to poor investment decision making by government, crowding out private sector investment by state capital, or political capture of state investment through cronyism and corruption.[108]

Mazzucato defines this active role as "entrepreneurial" and founded on four key tasks that also establish a baseline to reduce the risks of government failure: (1) set the direction and path for transformation; (2) design benchmarks that allow public policies to be effectively assessed on a cost-benefit basis; (3) enhance institutional design to build structures that have the capacity to manage risk; and (4) upgrade the effectiveness of public investment to socialize both investment risk and returns to investment of public capital.[109] Critical to this framework is the state's direct execution of the public investment function through "mission-oriented" state investment banks, crafted from the remnants of traditional development banks.[110]

---

steps—inter alia, limiting government stimulus in a given market to the early stages of that market's development, allowing unsuccessful companies to fail in order to ensure a sustainable competitive marketplace, refraining from currency manipulation, and promoting sustained private investment—to ensure the long-term viability of a country's participation and growth within a given market).

105. Mariana Mazzucato, *Building the Entrepreneurial State: A New Framework for Envisioning and Evaluating a Mission-oriented Public Sector* 3 (Levy Econ. Inst. of Bard Coll., Working Paper No. 824, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2544707.

106. *See generally id.* (arguing for a government-market relationship wherein the government takes the role of creating and shaping markets as well as distributing risks and rewards among market participants).

107. *Id.* at 4.

108. *Id.*

109. *Id.* at 5–11.

110. Mariana Mazzucato & Caetano C.R. Penna, *Beyond Market Failures: The Market Creating and Shaping Roles of State Investment Banks* 4–6 (Levy Econ. Inst. of Bard Coll., Working Paper No. 831, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2559873.

Developments banks are also a product of the market failure,[111] specifically the failure of financial markets to effectively allocate capital.[112] Gutierrez explains that the role of development banks in addressing market failures has been in response to a variety of frictions, for example, information asymmetries that suppress access to equity and debt—especially by nascent enterprises—and various externalities associated with investments in social projects that inhibit funding from the private sector.[113] However, as financial systems begin to deepen and the financial services offered by private-sector banks expand, competition from development banks can suppress growth of the private banking sector.[114] By the late the 1990s, financial deepening across many emerging market economies led to the disintermediation, privatization, or transformation of many development banks, thus forcing them to concentrate on sectors underserved by the private sector or to retool and build experience in other product areas, such as venture capital.[115] From this restructuring, Mazzucato's state investment bank emerges with two primary functions: (1) finance and (2) project coordination and facilitation.[116] Its finance function is goal- or mission-driven and significantly extends the original scale and scope of the traditional development bank to include four principle types of funding: (1) countercyclical finance to counter periods of economic slowdown; (2) project finance to fund capital development; (3) funding for social projects with public good features; and (4) investments in new and innovative sectors and technologies often through domestic venture capital funds.[117]

The NSE is rather muted with respect to direct investment, stressing the efficiency of the public deployment of capital while acknowledging both a structural and a countercyclical dimension to public investment. During periods of economic slowdown or stagnation, state intervention in a fiscal capacity might be directed to infrastructure and other public good projects to enhance economic growth. Structurally, where financial constraints exist, NSE prescribes using available surplus capital to finance domestic or regional projects that facilitate economic development, structural transformation, and sector diversification, including the strategic development of new industries.[118] This approach is quite restrained

111. Eva Gutierrez et al., *Development Banks: Role and Mechanisms to Increase their Efficiency* 2 (World Bank, Working Paper No. 5729, 2011), http://documents.worldbank.org/curated/en/912941468045550498/Development-banks-role-and-mechanisms-to-increase-their-efficiency.

112. *Id.* at 3.

113. *Id.* at 5–6.

114. *Id.* at 4–5.

115. *See id.* at 3, 6.

116. Mazzucato & Penna, *supra* note 110, at 4.

117. *Id.* at 4–5.

118. LIN, *supra* note 82, at 30.

when juxtaposed with the active financial role prescribed by Mazzucato, particularly in innovation, which is itself justified by market inefficiencies stemming from information asymmetries and high transaction costs.[119] This conclusion is also especially relevant because state investments can complement other broader government initiatives in financial deepening by directly seeding the development of local markets for private equity.[120]

The project coordination role of Mazzucato's state investment bank is no less critical but is often underrepresented in discussions that operationalize development finance. In addition to providing financial services, development finance institutions play an extended role in coordinating complex networks of principals through the various dimensions—design, funding, and execution—of projects under their mandate.[121] These project dimensions may include the activities of various state or private agencies or service providers.[122] Subsidiary to its financing role, Mazzucato's investment bank may serve as a lead not only at the deal level but also in contributing to national economic policy planning, assisting in identifying and prioritizing investments in strategic sectors and clusters, cultivating knowledge and skill building, and promoting strategic trade and investment.[123]

IV. INSTITUTIONS, MARKET INEFFICIENCIES, AND CAPITAL FLOWS: REVISITING THE LUCAS PUZZLE

In 1990, Robert Lucas observed the phenomenon of foreign capital flows moving not from developed or "rich" to "poor" countries, as predicted by economic theory, but rather from poor countries to rich.[124] The accumulation of surplus capital in stabilization and savings funds in resource economies, along with its subsequent investment as outward portfolio flows in deep financial markets of developed economies in Europe and North America, is—this Article argues—a manifestation of the so-called Lucas "puzzle."[125] In fact,

---

119. Mariana Mazzucato & Caetano C.R. Penna, The Rise of Mission-Oriented State Investment Banks: The Cases of Germany's KfW and Brazil's BNDES 5 (Sept. 16, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2744613.

120. *Id.* at 3–6.

121. *See id.* at 6.

122. *See id.* at 7.

123. *Id.* at 5.

124. *See* Robert E. Lucas, Jr., *Why Doesn't Capital Flow from Rich to Poor Countries?*, 80 AM. ECON. REV. 92, 92 (1990).

125. *See* Phillipe Aghion et al., *When Does Domestic Saving Matter for Economic Growth* 3 (Harvard Bus. Sch., Working Paper No. 09-080, 2009), http://hbswk.hbs.edu/item/when-does-domestic-saving-matter-for-economic-growth.

when hydrocarbon prices have increased, this trend has accelerated.[126]

Lucas offered several hypotheses to explain this puzzle including, rather broadly, "political risks," which he loosely described as "capital market imperfections"[127] resulting in, for example, the expropriation or the nonenforceability of investment contracts or credit agreements.[128] Since then, this puzzle has been widely studied. Explanations have focused structurally on economic fundamentals or on international capital market imperfections.[129] Alfaro et al., in a thorough review of the empirical literature in 2005, found that the leading explanation for relatively low levels of capital movements "downhill"—i.e., to capital-constrained economies—during the period between 1970 and 2000 was low institutional quality, defined primarily in terms of country risk parameters related to investment profile and the quality and stability of government, bureaucratic, and legal institutions.[130] Extensions of institutional explanations include, more generally, the quality of local financial institutions, the depth of local financial markets, and the ability of the local financial system to effectively intermediate the flows of foreign capital.[131] Prasad et al., for example, propose that the slow movement of capital from rich to poor countries may be indicative of financial and other structural impediments that limit a country's ability to absorb foreign capital.[132]

NSE—consistent with Lucas—cautions that without requisite enhancement of local infrastructure and the development of competitive domestic sectors, capital accumulation may drive lower returns on capital and so prompt outflows of capital to economies offering higher returns on capital.[133] To complement public and other forms of private domestic investment, NSE encourages direct

---

126. *See* Michael Joffe, Why Does Capital Flow From Poor to Rich Countries? 2–3 (2015) (unpublished manuscript), https://aeaweb.org/conference/2015/retrieve.php?pdfid=985 (observing that the outward flow of capital from the developing economy of China to the United States was similar to the outward capital flow of oil-rich nations that depend on foreign-currency hydrocarbon sales for income).

127. *See* Lucas, Jr., *supra* note 124, at 94.

128. *See id.* (describing, inter alia, the "political risk" inherent in foreign capital investments).

129. Laura Alfaro et al., *Why Doesn't Capital Flow from Rich Countries to Poor Countries: An Empirical Investigation* 1 (Nat'l Bureau of Econ. Res., Working Paper No. 11901, 2005), http://www.nber.org/papers/w11901.pdf.

130. *Id.* at 2.

131. *See* Eswar Prasad et al., *The Paradox of Capital*, FIN. & DEV., Mar. 2007, 1, 18–19.

132. *Id.* at 19. These include specifically weak domestic financial institutions or repressed financial markets that inhibit the intermediation of foreign investment.

133. *See* LIN, *supra* note 82, at 98–99.

foreign investment and advocates liberalizing a state's investment regime for inward direct investment.[134] Especially in competitive sectors of the domestic economy, direct foreign investment is generally of longer tenure and considerably more stable than portfolio flows or bank loans and thus poses less risk of capital flight.[135] Perhaps more importantly, direct investment is often accompanied by other critical tangible assets—technology, managerial expertise, market access, etc.—that can contribute directly to the state's broader development agenda.[136]

Nonetheless, openness to foreign capital, while a necessary condition,[137] is not sufficient to increase inward capital flows in light of other market imperfections. Poor institutional quality represents a structural form of market failure that is difficult to overcome without comprehensive structural reform, which is laborious to design, sequence, and execute.[138] Such reforms also require a high degree of political consensus building that often leads to protraction.[139] Intermediate measures to remove risks and lower barriers arising from a country's investment-risk profile—such as bilateral or multilateral trade and investment treaties[140]—serve to reduce some structural barriers, including those related to expropriation, fair and equitable treatment, repatriation, or dispute resolution.[141] However, these restraints are not capable of fully mitigating the effects of other impediments or market imperfections, including those related to basic agency issues or information

134. *Id.* at 29.
135. *Id.* at 34–35.
136. *Id.*
137. Dennis Reinhardt et al., *International Capital Flows and Development: Financial Openness Matters* 20–21 (Bank of Eng., Working Paper No. 472, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2280307.
138. *See* Alfaro et al., *supra* note 129, at 2–3 (noting that the improvement of institutional quality in Turkey—seen as a necessary predicate for triggering foreign direct investment—took drastic measures, such as constitutional change).
139. *See* Firat Demir, *Effects of FDI Flows on Institutional Development in the South: Does It Matter Where Investors Are From?* 78 WORLD DEVELOPMENT 341 342–43 (2016), http://www.sciencedirect.com/science/article/pii/S0305750X15002235.
140. Here, I acknowledge with appreciation, Professor Kish Parella of Washington & Lee University School of Law, whose inquiries during and after the symposium contributed directly to extending my earlier research on market inefficiencies and institutional quality to include specifically bilateral and multilateral investment treaties.
141. *See* Vineet Bhagwat et al., A BIT Goes a Long Way: Bilateral Investment Treaties and Cross-Border Mergers 4–5 (Sept. 16, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2872989 (finding that bilateral investment treaties serve to effectively reduce political risk by acting, up to a certain point, as a surrogate for institutional quality).

asymmetries, that might inhibit foreign investment.[142] While these issues exist for both public- and private-market transactions, they are especially pronounced in private markets involving illiquid assets such as real or operating assets, property, or projects.[143]

Such circumstances are not without parallel, even in markets with strong institutional foundations. Substantial uncertainty arises in private transactions due to a higher degree of asymmetric information and the need to effectively align incentives between parties.[144] These conditions can give rise to agency conflicts that distort the risk-return parameters that define the original transaction for the investor.[145] Venture capital structures based upon a private ordering of deal terms, which include both positive and restrictive negative covenants, facilitate intermediation even in the face of significant market imperfections.[146] However, even if institutional quality is able to ensure effective enforceability, contracts alone are not sufficient to fully intermediate such markets.

Repeatability in private equity transactions is frequently the result of longstanding relationships through which a level of trust is developed amongst both co-investment partners and entrepreneurs.[147] These informal structures can supplement the role of institutions[148] and serve to enhance both the quality of information and the alignment of stakeholder incentives to potentially lower risk thresholds.[149] This result is consistent with

---

142. *See id.* at 5 (noting that countries with the highest levels of political risk and the lowest levels of institutional quality have serious credibility issues that preclude the effectiveness of bilateral investment treaties).

143. *See* Josh Lerner & Antionette Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity* 3–4 (Nat'l Bureau of Econ. Research, Working Paper No. 10348, 2004), http://www.nber.org/papers/w10348 (noting that private equity groups will often take relatively invasive measures, such as retaining a majority on an entity's board of directors and retaining majority equity ownership in an entity, to compensate for poor contractual protections in developing economies).

144. *Id.* at 7 (noting that several studies exist concerning the risks venture capital and private equity firms face investing *within* the United States, a developed economy).

145. *See id.* at 4 (observing that countries with higher institutional quality and developed common law legal systems see higher levels of private equity financing—the implication, of course, being that risk-reward parameters are closer to the ideal than those of a less-developed country).

146. *Id.* at 3–4.

147. *See generally Value Creation: Proven Repeatability*, PRIV. EQUITY INT'L, Dec. 2016/Jan. 2017, at 6–7 (describing limited co-investment partners as desiring sustainable, consistent results from their general investment partners, private equity firms).

148. *See* Lerner & Schoar, *supra* note 143, at 3–4 (noting examples of techniques used by private equity firms, such as retaining a majority of equity in the entity in which the firm is investing, as a substitute for institutional quality in a developing country).

149. *See id.*

the Lucas puzzle and explanations related to institutional quality.[150] In turn, this observation raises an additional question concerning the development role of SWFs: can domestically focused SWFs reduce information and agency barriers and navigate local market and institutional frictions to catalyze foreign capital flows for development?

V. SWFS IN ECONOMIC DEVELOPMENT: BUILDING INSTITUTIONS "FIT FOR PURPOSE"

A base of contemporary public policy, grounded in macroeconomic theory and empirical evidence, accordingly establishes a rationale for a role for the state in economic development. Debate, however, persists on the advisable scope of state engagement as facilitator versus activist. Nonetheless, consensus exists that both the failure of markets and the deficiencies of state institutions can impact the effectiveness of development programing and the efficiency of public investment.[151] The continuing growth in the number of SDF or SIFs,[152] coupled with the expansion of domestic SWF mandates,[153] suggests that governments will use these institutional structures to address public investment requirements. Mazzucato and Penna accept and advocate for an active and entrepreneurial state as a "mission-oriented" investor in economic development, diversification, and transformation and outline two key roles for state investment institutions: finance and project coordination.[154] Importantly, as Mazzucato emphasizes, if government intervention is to be justified by market failure, the intervention cannot itself increase costs—both internal and external—so as to render such action inefficient and, on balance, more costly.[155] What, then, are necessary parameters of optimal design for such state institutions—SWFs—to enhance the quality and efficiency of public investment for development?

150. *See* Prasad et al., *supra* note 131, at 18–19 (noting that weak financial systems present issues with the efficient intermediation of capital, which can be a disincentive for foreign investment).

151. *See* Mazzucato, *supra* note 105, at 4.

152. *See* Mazzucato & Penna, *supra* note 119, at 1 (noting the increased role state investment banks have played in "funding the real economy" as private investment retreats from the arena).

153. Alan Gelb et al., *Should Sovereign Wealth Funds Finance Domestic Investments? The Opportunities and the Risks*, GREAT INSIGHTS, Sept. 2004, at 24, 24 (2014).

154. *See* Mazzucato, *supra* note 105, at 12–13.

155. *Id.* at 7.

A. *Overlapping Mandates*

No state investment institution will be a panacea for the ills of government inefficiency in public finance, particularly under the dynamic conditions found in developing or transforming economies. If these institutions are to contribute to, rather than detract from, efficient public investment and advance state economic goals, their investment policy and execution should be guided by a defined national development agenda[156] and their operating model designed to minimize the net costs of government intervention.[157] Public investment is inherently plagued by a variety of challenges, some resulting from poor capacity and weak governance.[158] These ailments can be accentuated when government investment institutions with even partially overlapping mandates compete for investments as well as political, financial, and human resources, which then leads to redundant costs, fragmented programs, and inefficient deployment of public capital.[159] Consequently, domestic SWF mandates should be carefully crafted to avoid increasing the fixed institutional costs of public investment while complementing, rather than duplicating, the investment and funding mandates of other state development finance institutions—including national development banks, development or economic ministries, and planning agencies.[160] As important, institutional capacity and governance must be built out consistently with the scope of the mandate.

The United Arab Emirates stands out as a state with multiple state investment institutions, including a development bank, state capital corporations, and a number of SWFs.[161] This occurrence is, in part, a function of the federal nature of the government and the independence of the nation's individual emirates.[162] However, this

---

156. *See* Gelb et al., *supra* note 67, at 22. The Nigeria Infrastructure Fund ("NIF"), one of three subfunds that constitute the Nigeria Sovereign Investment Authority, invests, for example, under a Five-Year Infrastructure Investment Rolling Plan prepared specifically to provide strategic guidance for NIF investments. *See id.* at 14 (providing more background on the NIF).

157. *See id.* at 10 (noting that the domestic spending and operations of a SWF must be coordinated with a country's existing economic policy so as to minimize the risk of doing more harm than good).

158. *Id.* at 8.

159. *Id.*

160. *See* Halland et al., *supra* note 49, at 20–21.

161. *Sovereign Wealth Fund Rankings*, *supra* note 10.

162. *See United Arab Emirates*, CENT. INTELLIGENCE AGENCY: WORLD FACTBOOK, https://www.cia.gov/library/publications/the-world-factbook/geos/ae .html (last visited Oct. 28, 2017) (noting the seven states that comprise the membership of the United Arab Emirates); *see also, e.g.*, SOVEREIGN WEALTH FUND INITIATIVE, PROFILE: MUBADALA DEVELOPMENT COMPANY 1 (Mar. 2013), http://fletcher.tufts.edu/~/media/Fletcher/Microsites/swfi/pdfs/Spring%202013 %20Bulletin/Mubadala%20Fund%20Profile.pdf (observing the individual state ownership of one of the public funds in the United Arab Emirates).

circumstance is also present within emirates such as Abu Dhabi, which has had as many as four globally recognized SWFs.[163] In 2016, this emirate announced plans—since completed—to merge Mubadala and the International Petroleum Investment Corporation ("IPIC").[164] The merger was designed to streamline investment operations across the two institutions and reduce operating costs in the combined entity by about 20%[165] while generating additional economies of scale.[166] Concerns about governance and interfund rivalry and competition, leading to suboptimal investment outcomes, were also linked to this decision.[167]

B. *Crowding Out vs. Crowding In: The Role Of Equity Capital*

Divergence from a well-defined investment policy can also lead to externalities and frictions. Domestic investments by SWFs should adhere closely to an investment policy established by their government owner or sponsors in order to be consistent with the fund's purpose and domestic mandate.[168] In this regard, investments should be independent of political influence and without risk to the integrity of national budgets, to the stability of the macroeconomy, or of capture by agency interests.[169] Similarly, SWFs investing in domestic markets should carefully evaluate and eschew investments that do not contribute positively to broader economic or development outcomes. This advised approach includes, in particular, investing competitively against the private sector in functioning markets that are, themselves, capable of efficiently intermediating private capital.[170] Such "crowding out" of private

---

163. According to the Sovereign Wealth Fund Institute's rankings, these included the Abu Dhabi Investment Authority, the Abu Dhabi Investment Council, Mubadala, and the International Petroleum Investment Corporation. *See Sovereign Wealth Fund Rankings*, *supra* note 10.

164. Nicolas Parasie, *Abu Dhabi to Merge Two State Investment Funds*, WALL ST. J. (June 29, 2016, 6:04 AM), http://www.wsj.com/articles/abu-dhabi-to-merge-two-state-investment-funds-1467184665.

165. Dania Saadi & Mahmoud Kassem, *Mubadala and IPIC to Merge After Resolution from Abu Dhabi Crown Prince*, NAT'L (June 29, 2016, 4:00 AM), http://www.thenational.ae/business/economy/mubadala-and-ipic-to-merge-after-resolution-from-abu-dhabi-crown-prince.

166. Arif Sharif, *Why Abu Dhabi's Two Biggest Investment Funds Are Merging: Q&A*, BLOOMBERG (June 30, 2016, 12:11 AM), http://www.bloomberg.com/news/articles/2016-06-29/why-abu-dhabi-s-two-biggest-investment-funds-are-merging-q-a.

167. *See* Michael Turner & Robert Hogg, *IPIC's 1MDB Row Likely Driver for Mubadala Merger*, REUTERS (June 29, 2016, 10:16 AM), http://www.reuters.com/article/abu-dhabi-ma-mubadala-ipic-uae-idUSL8N19L1WX.

168. Gelb et al., *supra* note 67, at 22.

169. *Id.* at 24–25.

170. *See* Clark & Monk, *supra* note 56, at 13.

sector interests can suppress the development of domestic capital markets and accentuate capital market frictions.[171]

Aligning mandates with investment policy requires buildout of capacity to invest in specific components of the capital structure.[172] Investment in development and economic transformation exploits private information to fund long-horizon investments using hybrid capital structures of both debt and equity.[173] Development—and even private sector—banks are well equipped to finance debt placements.[174] While SWFs employ a diversified use of equity and equity-linked instruments, along with debt and private credit,[175] they are especially well suited to provide risk capital in the form of equity. Like private equity firms and other direct investors in real assets, SWFs will be exposed to project-specific, idiosyncratic risks.[176] By employing a portfolio approach to risk management, SWFs can budget and diversify risk effectively to reduce the state's aggregate investment risk.

Equity capital affords the state flexibility and control of strategic domestic projects, providing greater scope within which to utilize information and other strategic advantages across a range of economic goals—for example, to (1) accelerate state sector privatization; (2) intermediate infrastructure build-out; (3) promote employment by strengthening demand factors, while encouraging sources of domestic competition; and (4) cultivate and finance both technical and process innovation in order to promote financial system deepening and development.[177] These initiatives require an active approach to investment monitoring and governance, which would allow the state, through the SWF, to more effectively manage project outcomes against key socioeconomic performance indicators.[178]

Equity capital also offers more flexibility to align the state's interests with those of both foreign and private domestic capital. This capability is especially critical to reducing institutional failure

---

171. *See id.*

172. *See id.*

173. *Id.*

174. For background showing the ability of these banks, see *Development Finance Statistics*, OECD, http://www.oecd.org/dac/stats/development-finance-institutions-private-sector-development.htm (last visited Oct. 28, 2017).

175. *See generally Sovereign Wealth Funds and Their Investments in Private Equity*, PRIVATE EQUITY SPOTLIGHT, MAY 2015, https://www.preqin.com/docs/newsletters/pe/Preqin-PESL-May-15-Sovereign-Wealth-Funds.pdf.

176. Clark & Monk, *supra* note 56, at 13.

177. *See* Shai Bernstein et al., *The Investment Strategies of Sovereign Wealth Funds* 6–7 (Harvard Bus. Sch., Working Paper No. 09–112, 2009), http://www.hbs.edu/faculty/Publication%20Files/09-112.pdf.

178. *See* Abdullah Al-Hassan et al., *Sovereign Wealth Funds: Aspects of Governance Structures and Investment Management* 15, 19, 21 (Int'l Monetary Fund, Working Paper No. 13/231, 2013), https://www.imf.org/external/pubs/ft/wp/2013/wp13231.pdf.

as it drives market discipline into deal structure and pricing and, further, can validate the financial viability of investments.[179] Moreover, effective deployment of equity capital can also reinforce the state's ability to earn commercially reasonable returns on the risks it takes. A number of SWFs with discrete domestic mandates are, in fact, required to seek third-party participation through charter-based restrictions on the percentage of capital they can invest in any transaction.[180]

The Russia Direct Investment Fund, for example, is mandated to secure co-investment that matches its commitment.[181] The fund—which was formerly administered by Vnesheconombank, Russia's State Corporation Bank for Development and Foreign Economic Affairs[182]—can invest "up to fifty percent of ownership" in any single project to serve as a catalyst for the infusion of foreign direct investment, talent, and technologies into Russia.[183] The fund's long-term co-investment partnerships include other SWFs, such as China Investment Corp., Korean Investment Corp., Mubadala, and Qatar Holding.[184]

CPD-Equity, an Italian SWF, likewise targets minority stakes.[185] The fund, formerly Fondo Strategico Italiano,[186] is a subsidiary of Italy's state investment company, La Cassa Depositi e Presditi, with share ownership open to other institutional investors, both Italian and foreign.[187] CPD-Equity acquires minority positions in companies of "significant national interest," both directly and through joint ventures and international or domestic co-investment agreements.[188]

Restrictions on percent ownership reduce the risk of "crowding out" private capital.[189] In fact, an optimally designed SWF, in the

---

179. *See* Håvard Halland, *Development Finance Frontline: Senegal's Strategic Investments Fund*, WORLD BANK (Apr. 22, 2016) http://blogs.worldbank.org/psd/development-finance-frontline-senegal-s-strategic-investments-fund.

180. *See, e.g.*, SANTIAGO PRINCIPLES, *supra* note 13, at 34–35.

181. *About Us*, RUSSIAN DIRECT INV. FUND, https://rdif.ru/Eng_About/ (last visited Oct. 28, 2017).

182. *See Duma Deputies Introduce Bill to Recognize RDIF as State Stock Company*, RUSSIAN DIRECT INV. FUND (Mar. 29, 2016), https://rdif.ru/Eng_fullNews/1660/.

183. *See Russia 2016 Investment Climate Statements*, U.S. DEP'T STATE (July 5, 2016), https://www.state.gov/e/eb/rls/othr/ics/2016/eur/254409.htm.

184. *See Partnerships*, RUSSIAN DIRECT INV. FUND, https://rdif.ru/Eng_Partnership/ (last visited Oct. 28, 2017).

185. CDP EQUITY, http://en.cdpequity.it (last visited Oct. 28, 2017).

186. *About Us*, *supra* note 61.

187. *See Invest with CDP Equity*, CDP EQUITY, http://en.cdpequity.it/what-we-do/invest-with-cdp-equity.kl (last visited Oct. 28, 2017).

188. *What We Do*, CDP EQUITY, http://en.cdpequity.it/what-we-do/ (last visited Oct. 28, 2017).

189. Mazzucato & Penna, *supra* note 110, at 30–31.

presence of market frictions, can function well as lead investor in the execution of its domestic mandate and serve as a conduit to actively "crowd in" foreign and/or private capital.[190] In doing so, a SWF can establish the state as a credible third-party co-investment partner that can leverage proprietary networks to source, structure, and de-risk domestic investment opportunities.[191] Moreover, when the state's interests are aligned with those of foreign investors through an equity structure that shares risks and returns, a SWF with extensive local market knowledge and networks has the capacity and incentive to reduce both market and government frictions to foreign capital.[192]

The Ireland Strategic Investment Fund ("ISIF") provides a useful illustration of a SWF designed to promote economic activity and employment while mandated to invest on a commercial basis.[193] The ISIF was established in 2014 with the €7.60 billion of capital remaining from the restructuring of the Irish National Pensions Reserve Fund following its recapitalization of Allied Irish Banks and the Bank of Ireland.[194] This fund is managed by the National Treasury Management Agency, a state agency that provides asset and liability management services to the Irish government.[195] The fund has a well-articulated "Double Bottom Line" investment policy whose objective is to construct a diversified portfolio of domestic assets.[196] Moreover, the ISIF invests over a three-to-five-year horizon and leverages its flexibility, long horizon, and status as "a sovereign investment partner to fill investment gaps and enable transactions which would not otherwise easily be completed."[197] The fund maintains a high target allocation—eighty percent—to investments with high economic impact,[198] i.e., investments that make a net-positive contribution to the economic performance of the country in terms of output, profitability, exports, capital

---

190. Mazzucato and Penna attribute a similar quality to state investment banks. *Id.* at 46.

191. *See* Clark & Monk, *supra* note 56, at 13.

192. *See* Al-Hassan et al., *supra* note 178, at 14–15, 17, 22.

193. IR. STRATEGIC INV. FUND, INVESTMENT STRATEGY: EXECUTIVE SUMMARY 1–2 (2015), http://isif.ie/wp-content/uploads/2016/03/ISIFInvestmentStrategyExecutiveSummaryJuly2015.pdf.

194. Jess Delaney, *Can Strategic Investment Funds Make a Difference?*, INSTITUTIONAL INV. (Nov. 23, 2016), https://www.institutionalinvestor.com/article/b14z9p7j0vc74z/can-strategic-investment-funds-make-a-difference; *History of the Fund*, IR. STRATEGIC INV. FUND, http://isif.ie/about-us/history/ (last visited Oct. 28, 2017).

195. *Id.*

196. *How We Invest*, *supra* note 51.

197. *Ireland Strategic Investment Fund,* NAT'L TREASURY MGMT. AGENCY, http://www.ntma.ie/annualreport2016/Ireland_Strategic_Investment_Fund.html (last visited Oct. 28, 2017); IR. STRATEGIC INV. FUND, *supra* note 193, at 4.

198. *Id.*

expenditure, and employment.[199] Also, to leverage its capital base and to validate the commercial viability of deal structures, the fund actively invests with co-investors.[200]

C. Project Development and Management

As an institutional investor, rather than a government ministry, a domestically focused SWF is analogous to a private equity investor and will be required to perform both financial and operational functions related to its projects. These tasks might include deal origination and deal structuring, due diligence, investment monitoring, servicing, risk management, and exit planning.[201] To perform these functions effectively and efficiently, the SWF management and staff must have extensive financial knowledge and operational experience as well as project management skills to facilitate coordination of project tasks among key stakeholders and delivery channels.[202] Under conditions of severe capacity constraints, as may be the case in less-developed economies or with governments with limited capacity to originate "bankable" projects,[203] SWFs can serve as a bridge between government counterparties and the private sector to coordinate project origination and liberate underfunded opportunities.

Here, the Senegal Strategic Sovereign Investment Fund ("FONSIS") provides an interesting case in point.[204] FONSIS, partially capitalized with state-owned assets,[205] has a mandate to invest in equity and quasi-equity projects in strategic sectors defined in Plan Senegal Emergent—Senegal's reference agenda for economic development.[206] The fund is designed to fulfill three principal roles.[207] First, as developer, the fund is responsible for

---

199. *Id.*

200. *Id.*

201. *See* Alan Gelb et al., *Sovereign Wealth Funds and Domestic Investment in Resource-Rich Countries: Love Me, or Love Me Not?*, *in* ECON. PREMISE 1–2 (World Bank, Poverty Redution & Econ. Mgmt. Network, No. 133, Jan. 2014), http://siteresources.worldbank.org/EXTPREMNET/Resources/EP133.pdf; Al-Hassan et al., *supra* note 178, at 22–23; INT'L FORUM OF SOVEREIGN WEALTH FUNDS, NEW CHALLENGES, PRIVATE MARKETS: SOVEREIGN WEALTH FUNDS' CHANGING INVESTMENT STRATEGIES 3 (2016), http://www.ifswf.org/sites/default/files/IFSWF%20New%20Challenges%2C%20Private%20Markets.pdf.

202. *See* Al-Hassan et al., *supra* note 178, at 13–14.

203. *See, e.g.*, Claire Milhench, *Home-Grown African Wealth Funds Seeking Foreign Partners to Fix Infrastructure Gap*, REUTERS (Jan. 25, 2017, 7:40 AM), http://www.reuters.com/article/us-africa-economy-infrastructure/home-grown-african-wealth-funds-seeking-foreign-partners-to-fix-infrastructure-gap-idUSKBN1591F5.

204. *See* Halland et al., *supra* note 49, at 8.

205. *Id.* at 8.

206. *Id.*

207. *What We Do?*, FONSIS, http://www.fonsis.org/en/who-we-are/what-we-do (last visited Oct. 28, 2017).

developing and structuring strategic projects "from scratch by finding financial and technical partners" under transparent tenders.[208] Second, as co-investor, the fund participates in local investments sourced from a range of technical and financial partners.[209] Finally, with regard to state assets, FONSIS is tasked with restructuring state holdings received as part of its original capital.[210]

D. *Politics and Governance*

Government failure also extends to the political capture of the public investment process to advance the personal or political goals of individual leaders, or even those of a circle of key elites. This result might occur through the budgetary process but also through extra-budgetary means.[211] Domestic investments by SWFs are especially vulnerable to such forms of capture.[212] These risks are genuine and would threaten the institutional credibility of a fund established to fulfill a domestic development mandate.[213] In designing a governance structure to support domestic investment, the critical objective is to ensure that the fund does not bypass or undermine macroeconomic management or otherwise become engaged in politically motivated transactions.[214]

Fundamentally, good governance rests at the foundation of effective institution building. Domestic mandates pose unique challenges, especially those emanating from political influence.[215] The Generally Agreed Principles and Practices ("GAPP" or "Santiago Principles")[216] establish a governance baseline for SWFs. The GAPP represent a body of soft law defined by a working group of SWFs in 2008 and are intended as a threshold of accepted practices for a state-owned investment program.[217] These principles are endorsed and implemented voluntarily by funds under the organizational order of the International Forum of Sovereign Wealth

---

208. *Id.*
209. *Id.*
210. *Id.*
211. *See* INT'L BUDGET P'SHIP, GUIDE TO TRANSPARENCY IN PUBLIC FINANCES: LOOKING BEYOND THE CORE BUDGET: 1. EXTRA-BUDGETARY FUNDS 3, http://www.internationalbudget.org/wp-content/uploads/Looking-Beyond-the-Budget-1-Extrabudgetary-Funds.pdf.
212. *See* ROLANDO OSSOWSKI & HÅVARD HALLAND, THE WORLD BANK GRP., FISCAL MANAGEMENT IN RESOURCE-RICH COUNTRIES: ESSENTIALS FOR ECONOMISTS, PUBLIC FINANCE PROFESSIONALS, AND POLICY MAKERS 84 (2016), http://documents.worldbank.org/curated/en/311721468011610982/Fiscal-management-in-resource-rich-countries-essentials-for-economists-public-finance-professionals-and-policy-makers.
213. *See* INT'L BUDGET P'SHIP, *supra* note 211.
214. *See* Halland et al., *supra* note 49, at 14, 22–23.
215. *See* OSSOWSKI & HALLAND, *supra* note 212, at 84.
216. SANTIAGO PRINCIPLES, *supra* note 13.
217. *Id.*

Funds ("IFSWF").[218] The GAPP number twenty-four in total and are organized into three pillars: (1) legal structure and objectives; (2) institutional structure and governance; and (3) investment and risk management.[219] As a body of accepted practice in investment management, the Santiago Principles emphasize the importance of well-established legal and governance structures in addition to well-defined processes in investment and risk management.[220] They also focus specifically on the clear public articulation of a fund's objectives, including those that diverge from strictly commercial goals.[221] Currently, thirty funds, as members of the IFSWF, have endorsed the GAPP and at least one-third of these have discrete domestic mandates.[222] This subset includes, among others, the Russia Direct Investment Fund, Khazanah, the ISIF, CDP-Equity, the Palestine Investment Fund, and Samruk-Kazyna.[223]

The GAPP were not drafted specifically as a governance framework for domestic mandates.[224] However, their endorsement and implementation can signal a commitment to practice good institutional governance.[225] Under the terms of the proposed Trans-Pacific Partnership ("TPP"), for example, SWFs are defined discretely as members of the IFSWF or any institution that has "endorse[d] the [GAPP]."[226] While precluded from providing "non-commercial assistance" to portfolio companies, in the form of "direct transfers of funds or . . . liabilities" or goods and services on commercially favorable terms,[227] SWFs—as defined—are themselves exempt from provisions under the TPP governing SOEs.[228]

Disclosure and reporting are essential elements of good governance and represent recurring themes in the GAPP, with some sixteen separate references overall. Because these principles are non-binding, the Santiago Principles cannot mandate effective

218. *Id.* The IFSWF is a member organization of SWFs that evolved from the former International Working Group of Sovereign Wealth Funds, originally convened by the International Monetary Fund. *Id.*

219. *Id.*

220. *Id.*

221. *See id.*

222. *Our Members*, IFSWF, http://www.ifswf.org/our-members (last visited Oct. 28, 2017).

223. *Id.*

224. SANTIAGO PRINCIPLES, *supra* note 13, at 3–6.

225. *See* Daniella Markheim, *Sovereign Wealth Funds and Protectionism*, HERITAGE FOUN. (Dec. 22, 2008), http://www.heritage.org/commentary/sovereign-wealth-funds-and-protectionism.

226. Trans-Pacific Partnership, *supra* note 32, at 17-1 (note that the United States has formally withdrawn from this agreement).

227. *Id.* Direct transfers are defined to capture grants, debt forgiveness, loans and loan guarantees of commercially favorable terms, and equity "inconsistent with the usual investment practice." *Id.*

228. *Id.* at 17-14 to -16.

reporting, particularly in the form of public disclosures.[229] As a result, the scope of SWF reporting tends to be discretionary, and the quality of disclosure varies widely as a function of a home country's legal, government, and business practices.[230] Notwithstanding, in necessary contexts—for example, when active issuers in global capital markets—SWFs comply with standard global issuing requirements and procedures on disclosure and reporting.[231] This practice is especially apparent in international credit markets where SDFs—e.g., Temasek, Khazanah, and Mumtalakat—have issued a variety of notes and bonds under detailed offering circulars.[232] These documents provide extensive financial and operational details of the fund, including subsidiary operations.[233] Although such disclosures do not provide a complete and transparent view into SWFs, they nonetheless supplement other reporting frameworks and contribute to monitoring by regulatory agencies, counterparties, and other key stakeholders.

Effective reporting also creates a scorecard against which the efficiency of public investment can be formally measured and tracked.[234] Benchmarking economic performance, in particular, can be challenging in its diversity and can require considerable data collection and analysis on a continuing basis,[235] which can also increase the costs of effective government intervention. The ISIF has developed an innovative approach to reporting on its dual mandates.[236] The fund reports conventionally on its financial performance and also regularly prepares a detailed accounting of the impacts—including on employment, turnover, exports, and profits—and regional spread of its investments.[237] This framework is publicly distributed and provides a recurring baseline against which to assess the efficiency and economic impact of the fund's investment program.

---

229. *See* SANTIAGO PRINCIPLES, *supra* note 13, at 5.

230. *See, e.g.*, Anna Gelpern, Hard, Soft, and Embedded: Implementing Prinicples on Promoting Responsible Lending and Borrowing 29–30 (Apr. 2012) (unpublished manuscript), http://unctad.org/en/PublicationsLibrary/gdsddf2012misc2_en.pdf.

231. Schena & Chaturvedi, *supra* note 46.

232. *Id.*

233. *See, e.g.*, *Temasek Bonds*, TEMASEK, http://www.temasek.com.sg/investorrelations/temasekbonds (last visited Oct. 28, 2017).

234. *See* Gelb et al., *supra* note 67, at 1–2, 10, 39.

235. *See* Jeremy Cowper & Martin Samuels, Performance Benchmarking in the Public Sector: The United Kingdom Experience 3 (1997) (unpublished manuscript), http://www.oecd.org/unitedkingdom/1902895.pdf.

236. *See* NAT'L TREASURY MGM'T AGENCY, IRELAND STRATEGIC INVESTMENT FUND: BASELINE ECONOMIC IMPACT REPORT AS AT 31 DECEMBER 2014, at 5 (2015), www.ntma.ie/download/ISIFEconomicImpactReportJuly2015.pdf.

237. *See, e.g.*, *id.* at 1.

CONCLUSION

Sovereign wealth funds are by no means immune to the government failures that plague state-led development. Not least are those that stem from the ineffective integration of a SWF into a national development agenda, persistent operating and investment capacity constraints, poor access to capital, political influence, poor governance, and the host of agency conflicts that arise from multiple, sometimes-competing stakeholders.[238] This Article has attempted to reconcile complementary yet diverging paradigms of economic development to identify distinct functional roles and institutional structures for SWFs to participate effectively in domestic public investment. This Article first set out to catalog the roles and organizational structures of existing SWFs, then it presented the economic rationale for an active state role in economic development derived from contemporary frameworks offered by "new structural economics" and the "entrepreneurial state." The Article also examined institutional barriers that inhibit flows of foreign capital, which might augment the state's resources available for development. Finally, the Article identified a series of organizational features and governance structures designed to overcome government failures in the public investment process and enhance the overall level of institutional quality. The ultimate test of their effectiveness as public investors in national development requires that SWFs contribute directly to national welfare and the development of a structurally sound and vibrant local economy—namely, that they generate both financial and economic returns.[239] Optimal institutional design warrants that funds do so while reducing the burden of government on the public investment process.

---

238. *See generally* Gelb et al., *supra* note 67.
239. *See* Gelb et al., *supra* note 201, at 3.

***