The Shield of Nationality

When Governments Break Contracts with Foreign Firms

There is extraordinary variation in how governments treat multinational corporations in emerging economies; in fact, governments around the world have nationalized or eaten away at the value of foreign-owned property in violation of international treaties. This even occurs in poor countries, where governments are expected to, at a minimum, respect the contracts they make with foreign firms, lest foreign capital flee. In *The Shield of Nationality*, Rachel L. Wellhausen introduces foreign-firm nationality as a key determinant of firms' responses to government breach of contract. Firms of the same nationality are likely to see a compatriot's broken contract as a forewarning of their own problems, leading them to fight or to take flight. In contrast, firms of other nationalities are likely to meet the broken contract with apparent indifference. Evidence includes quantitative analysis and case studies that draw on field research in Ukraine, Moldova, and Romania.

Rachel L. Wellhausen is an assistant professor of government and holds courtesy appointments at the McCombs School of Business and the Center for Russian, Eastern European, and Eurasian Studies at the University of Texas at Austin. She is co-editor of *Production in the Innovation Economy* (2014), an interdisciplinary volume emerging from the multi-year MIT project on the links between innovation and manufacturing in the United States and abroad. Wellhausen has published in the *Journal of Conflict Resolution, Business and Politics*, and *Systems and Synthetic Biology*. She has also worked in the political risk industry.

The Shield of Nationality

When Governments Break Contracts with Foreign Firms

RACHEL L. WELLHAUSEN
University of Texas, Austin

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

32 Avenue of the Americas, New York, NY 10013-2473, USA

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning, and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781107082762

First published 2015

Printed in the United States of America

A catalog record for this publication is available from the British Library.

Library of Congress Cataloging in Publication Data
Wellhausen, Rachel L.
The shield of nationality : when governments break contracts with foreign firms / Rachel Wellhausen.
pages cm
Includes bibliographical references and index.
ISBN 978-1-107-08276-2 (hardback)
1. Public contracts – Developing countries. 2. Business enterprises, Foreign – Government policy – Developing countries. 3. International business enterprises – Developing countries. 4. Investments, Foreign – Developing countries. 5. Developing countries – Commercial treaties. 6. Developing countries – Commercial policy. I. Title.
HD4420.8.W45 2015
346.02′3–dc23 2014027989

ISBN 978-1-107-08276-2 Hardback

Contents

1

Nationality and Leverage in a Globalized World

In May 2009, the slot machine hall at a Russian-owned casino in the Ukrainian city of Dnepropetrovsk caught fire. Nine people died. Ukraine immediately ordered the closure of the country's 100,000 gambling establishments. The Estonian firm Olympic Entertainment Group, owner of twenty-four casinos in Ukraine, sent its 655 employees home without pay.[1]

But just one day after the official shutdown, it appeared that "almost half" of Ukraine's casinos were back in operation.[2] Even the Russian firm that owned the charred casino opened its other branches. Observers speculated that political fights over the distribution of lucrative gaming licenses – which Russian and Ukrainian firms tended to win – were now being played out through selective law enforcement.[3]

The Estonian firm Olympic was in a bind: it could not legally reopen, but Ukraine's selective enforcement of the gambling ban privileged Russian and domestic firms at its expense. The Ukrainian government was breaking its legal commitments to provide Estonian firms fair treatment as codified in the Ukraine–Estonia Bilateral Investment Treaty. Olympic waited twenty-seven days before choosing to liquidate its assets, claiming that the Ukrainian state caused them approximately US$28 million in lost profits and damages.[4]

In an era of economic globalization, conventional wisdom would have it that a government like Ukraine's would seek to encourage investment from a firm like Estonia's Olympic. Ukraine, like other emerging economies around the

[1] Marson, James, "All Bets are Off: Russian and Ukraine Ban Gambling," *Time*: 2 July 2009.
[2] "Estonia's Olympic Hoping to Reopen Ukrainian Casinos," *Baltic Business Daily*: 18 May 2009.
[3] Brettell, Ashley, "Olympic Cashes in Ukraine Chips," *The Baltic Times*: 15 July 2009.
[4] Whatever settlement might have occurred between Olympic and the Ukrainian state is not public. However, a law firm did fail to persuade Olympic to sue the Ukrainian state, which it could have done per the terms of the Ukraine–Estonia treaty. Interview, law firm, Ukraine, 2009.

world, wants foreign direct investment (FDI).[5] FDI brings capital to capital-scarce locales and has the potential to bring tax revenue, employment, and spillovers to the domestic economy as well. The protection of private property rights, and certainly of foreign firms' property rights, is widely claimed to be the foundation for access to FDI.[6] Indeed, the Ukrainian government's broken commitment to Estonia's Olympic caused the firm to flee. Most costly to a government like Ukraine's, however, is the notion that such broken commitments send signals that deter not just a specific aggrieved firm but FDI in general. To violate commitments to protect foreign firms' property rights – in effect, to violate "contracts" made with foreign firms – is thought to scare off new firms and drive a wide swath of existing firms away.

But despite such predictions, the Ukrainian government's decision to violate its contract with Olympic is anything but extraordinary. Examples of government breach of contract with foreign firms abound.[7] Sometimes, as in the Ukrainian casino case, governments unlawfully privilege some foreign firms over others. The Greek firm OTE was promised a time-delimited monopoly when it bought the national Armenian telecommunications firm in 1998. However, the Armenian government forced renegotiation of that contract in 2004, and it facilitated the entry of a Lebanese-owned competitor in a non-transparent process. In 2012, a British mining firm sued Indonesia for allowing another firm to operate in its concession. Sometimes, governments discriminate against foreign firms in favor of domestic actors. In Uzbekistan, the Korean firm Daewoo invested in a textile firm in the mid-1990s, but the Uzbek government nationalized Daewoo's share after the firm achieved a leading position in the Uzbek cotton industry. Venezuela nationalized fourteen foreign firms in 2005 alone. By 2010, Kazakhstan fully nationalized the assets of the private Moldovan oil and gas firm Ascom after the Moldovan president sent Kazakhstan's president a letter urging just that (Chapter 6). Sometimes, foreign firms face straightforward discrimination. An American firm sued Oman in 2011 over the cancellation of its rights to a limestone quarry. A Turkish agro-industrial investor sued Turkmenistan in 2013, after the United Nations High

[5] As FDI flows into even the poorest countries, I prefer to extend the moniker "emerging" very widely. Thus, "emerging economy" in this book refers to what other sources might call "middle-income," "low-income," and "less developed" countries. The presumption is that emerging economies tend to face capital scarcity and to be capital-importers. They also have relatively weak domestic judicial institutions, implying that foreign firms look for other informal or formal means to ensure contract enforcement.

[6] E.g., De Soto 2000; Williamson 2000; Shleifer and Vishny 2002; Acemoglu and Robinson 2006; Rodrik 1997; Alfaro, Kalemli-Ozcan et al. 2008; Coase 1960.

[7] Foreign firms' views on an adverse government action are expected to be the trigger for costly actions toward the host government. Therefore, although blame in contract disputes is hotly contested, this book takes foreign firms' complaints as evidence of what I will call "government breach of contract." Government breach of contract refers to all events that foreign investors see as expropriatory, whether or not they are legally adjudicated as such. Chapter 2.

Commissioner for Refugees found that local criminal proceedings against the firm's president had violated his right to a fair trial.[8]

In fact, foreign firms have, at one time or other, accused the overwhelming majority of emerging-economy governments of violating the contracts they make to protect foreign firms' property rights. Governments around the world have sometimes nationalized, expropriated, or unlawfully eaten away at the value of foreign-owned property in a wide variety of industries. From 1990 to 2013, governments in some 110 countries nationalized at least 150 investments and were publicly sued by foreign investors well over 550 times in industries as varied as oil and gas, utilities, banking, services, transportation, manufacturing, media, and more.[9] These international legal actions represent only a slice of what one multinational executive calls pervasive instances of "everyday breach of contract" by governments in emerging economies.[10]

Nevertheless, many implicit and explicit contracts between foreign firms and host governments remain intact. Indeed, some 82,000 multinational corporations with over 800,000 foreign affiliates engage in FDI contracts with governments today, and the accumulated FDI stock in emerging economies reached US$6.6 trillion in 2010.[11] Host governments regularly respect contracts with foreign firms even when disputes arise.[12] Ukraine has backed off public threats to devalue the property of an American retailer. Bulgaria decided against nationalizing a major steel mill. Bolivia and South Africa maintain their commitments to some Bilateral Investment Treaties (BITs) even after withdrawing from others. Yet governments do not always prioritize the property rights of foreign firms, despite the expectation that foreign firms exert strong, steady pressure on them to do so.

In this book, it is assumed that foreign firms want their property rights to be respected, and they resist violations in ways costly to the host government in order to secure their property rights. Variation comes, however, in what foreign firms do or do not do to pressure a host government to respect its contracts. All foreign firms do not exert steady pressure on host governments to respect all contracts. Breach of a given firm's contract does not lead current and potential foreign investors to react en masse in ways costly to the government.

8 *Omar Faruk Bozbey v. Turkmenistan, CCPR/C/100/D/1530/2006.*

9 Hajzler 2012, Minor 1994. Author's records. United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). Accessed February 2014.

10 Interview, foreign firm in financial services sector, Moldova, 2009.

11 UNCTAD. Emerging economy FDI includes FDI into "developing countries" and "transition countries." It accounts for 35 percent of the world FDI stock as of 2010. In this book, the following are interchangeable: foreign firm, foreign investor, and multinational corporation. Some sources refer to this type of firm as a "transnational corporation." All of these terms refer to a firm with at least one affiliate in a foreign country.

12 "Host" refers to the country in which a foreign firm invests. "Home" refers to the country from which a foreign firm originates.

As we will see, foreign firms do not behave as a unified bloc even when observing contract breach in their own sector. To explain the varying pressures host governments face from foreign actors to maintain contact sanctity, I turn to a new explanation: firm nationality.

THE SHIELD OF NATIONALITY

Economic globalization is embedded in nation-states at both ends of the investment transaction. On one end, national governments sometimes break contracts with foreign firms. But nationality is equally important at the other end of the transaction: foreign firms' national origins shape the risk that host governments will break contracts.

Foreign firms of the same nationality, or "co-national firms," face common determinants of contract sanctity. These common determinants are the result of a set of institutional, political, and cultural factors. In particular, investor nationality is integrated into international investment law, as instruments like BITs make firms' access to legal remedies conditional on their national origins. Bilateral politics has always spilled over into foreign investment, when host governments change relations with a particular nationality of investor due to matters of war and peace or when responding to the more mundane tensions and cycles of diplomacy. Firms of certain nationalities share historical and linguistic ties with particular host countries that shape their vulnerabilities with the host government, for better or worse. In operational terms, co-national firms often share methods of financing and means of contracting that differentiate their interactions with host governments from those of other firms. All of these factors influence the status of co-national firms' contracts with host governments.

Of course, co-national firms vary: they sometimes seek markets and sometimes seek resources; they include both giant corporations and small enterprises; and they invest in a variety of sectors. But despite these differences, firms of the same nationality share many sources of contract risks. Shared risks make a co-national's relations with the host government relevant to the future of a firm's own contract: all else equal, threats to one firm are likely to spill over to co-national firms. Co-national firms share in a collective good of contract sanctity.

Because they share this collective good, firms have incentives to act in ways costly to host governments when a co-national's contract sanctity is threatened. Co-nationals can impose costs on a government in two ways. First, new information on threats to contract sanctity can lead firms of the same nationality to change their investment behavior. Current investors can draw down FDI by stopping reinvestment, incrementally withdrawing capital, changing from direct investment into trade or sub-contracting relationships, or totally exiting the host country. Potential investors into the host country can divert capital away from the host country to friendlier climes with better track records for respecting contracts. The threat of foregone FDI from one national group can be great enough to pressure a capital-poor host government to honor contracts.

The second form of costly action co-nationals can take in response to breach draws on the unique resources that national groups of firms have at their disposal. Home country diplomats can provide co-nationals with privileged leverage against host government officials. Diplomats can raise the stakes of breach through issue linkage. When potential trade sanctions, the loss of bilateral aid, or other diplomatic penalties compound the costs of lost capital, host governments can feel squeezed to respect a national group's contracts. Additionally, home governments have aided their investors by signing treaties that ensure their firms have access to international law. These treaties, of which BITs are the most common, allow firms from the home country to sue host governments – often without resorting to local courts in the host country and without the explicit approval of the home government. In this way, co-national firms can use home-country institutions to aid in the enforcement of their property rights without a diplomat in the room. Finally, co-national firms often overcome barriers to collective action by organizing formal or informal national investor associations. Such groups can help co-national firms lobby home governments for support as well as lobby host governments directly.

All told, co-national firms have considerable power to stop government breach of contract: they can credibly threaten to divert capital; they can benefit from issue linkage and bilateral relations between the home and host countries; they can access lobbyists in the form of nationality-tied investor associations and diplomatic missions; and, often, co-national firms can exercise legal rights reserved to them by their nationality.

Put differently, co-national firms in a given host country benefit from a kind of common shield that helps preserve their contract sanctity. Nationality is a focal point for information about changes to the sanctity of a firm's contracts with the host government, because shared risks make the effectiveness of one firm's defenses against breach relevant to every other co-national firm's defenses. Nationality also provides resources that firms can use to battle back against host government threats to contract sanctity. Diplomats and national investor groups can protect against and deflect threats, giving co-national actors reason to stand side by side. Depending on the particular bilateral relations between the home and host country, a shield might be stronger or weaker.[13] Regardless, if the shield is penetrated, the contract sanctity of not one but all co-national firms is at stake.[14] But when a contract is broken with a firm of one nationality, other nationalities' shields are likely to remain intact. To support a firm of a different nationality in its contract dispute would mean emerging from behind one's

[13] Does the size of the shield matter? Quantitative and qualitative evidence goes to show that host governments can and do break contracts with both the biggest and smallest of national investor groups. Chapters 4, 5, and 6.

[14] As a pertinent contrast, firms in the same industry do not share a shield regarding contract sanctity. "Co-industrial" firms can sometimes come together to lobby over broad policies affecting the industry as a whole, but when it comes to contracts, one firm's loss can be its competitor's gain. Chapter 3.

shield. Certainly, all firms tend to prefer to stay out of the spotlight and maintain the status quo (or better) in their interactions with a host government. But co-national firms and their diplomats are more likely to be pushed to act in costly ways following breach, because a given breach puts co-nationals' contract sanctity at stake, too. These, in brief review, are the ideas that will be explored in the book.

DO MULTINATIONAL CORPORATIONS EVEN HAVE NATIONALITIES?

The idea that nationality creates a shield for co-national firms is built on the premise that multinational corporations have a nationality in the first place. This contention is controversial, as the claim that multinational corporations have no nationality is a common one. Already in the late 1990s, scholars wrote of "outdated notions of home country" in a "borderless world."[15] The "coming irrelevance of corporate nationality" meant that "economic gain can be pursued independently of sovereignty."[16] In 2008, *The Economist*'s special report on the "stateless multinational" predicted that "truly global" firms would be the next phase in the evolution of the multinational corporation.[17] Multinational corporations' marketing departments have taken advantage of the idea that national borders are irrelevant: HSBC is "the world's local bank," IBM provides "solutions for a small planet." Other firms have shed their nationality-tied names: British Petroleum is BP, and Royal Dutch Shell commonly drops the first two words. For member states of the European Union, many think (or hope) that the nationalities behind commerce now go unnoticed. Most-favored-nation (MFN) clauses are widespread in international treaties, giving some multinational corporations the same treatment whatever their particular home country negotiated. In an interview, the local director at a multinational affiliate in Ukraine told me: "We are technically British, people think we're American, and I'm Australian … but what does it matter anyway?"[18]

Multinational corporations' detractors, too, often characterize them as entities outside of the bounds of national governments. Anti-globalization advocates point to the popularity of firm registrations in tax havens to demonstrate the slipperiness of nationality. When multinational corporations register their operations outside of the country that common sense would say is their "true" home, they free themselves from the "true" home's legal restrictions. This wrinkle in home-country registration, the argument goes, makes firms

[15] Stopford 1998, Ohmae 1999.
[16] Kobrin 2001, Evans 1997.
[17] "In praise of the stateless multinational," *The Economist*, 18 September 2008. Days later, as the financial crisis set in, multinational corporations began to pay close attention to their home countries – the source of bailout funds.
[18] Interview, British firm in manufacturing, Ukraine, 2011.

supra-national actors for whom national origin is but an accident. Much like the Seattle protesters at the 1999 World Trade Organization (WTO) meeting, the Occupy Wall Street movement laments that in a world where multinational corporations are autonomous and unaccountable, "no true democracy is attainable."[19] In this view, corporations can make emerging-economy governments adopt policies that corporations prefer, like weak environmental, labor, and regulatory standards. That power has to do with economics and has little to do with home country governments; external pressure on domestic policy comes via Wal-Mart rather than diplomatic channels. Many scholars argue that host countries' reliance on foreign capital gives governments little to no space to resist the dictates of international economic actors.[20] Again, the assumption is that multinational corporations exert power on their own, undirected by home country governments.

Recent scholarship has added considerable nuance to this picture. Mosley and Locke find that corporations sometimes have power to shape labor rights in emerging economies, but they identify conditions under which corporate decisions can strengthen rather than weaken labor rights.[21] Nevertheless, the notion that multinationals can exert their influence without the backing or approval of home country governments is the same. Another literature identifies the circumstances under which multinationals are not policymakers, identifying persistent variation in national policy in issue areas as varied as trade, intellectual property, environment, and finance.[22] But again, this research agenda begins from the premise that multinational corporations are powerful, independent forces in the global economy. In this vein, many scholars choose to call firms investing abroad "transnational" corporations, emphasizing that their origins are not key to their definition.[23]

In stark contrast to these views portraying multinational corporations as trans- or meta-national, this book shows how powerful a foreign firm's nationality remains. Part of the power of nationality is in its ability to help foreign firms focus on information relevant to the status of their contracts with host governments. In an information-saturated world, prioritizing co-national firms' experiences allows firms to efficiently economize on search costs, ever more important as more and more firms enter into more and more relationships with host governments. The other source of nationality's power is in home governments' continued ability to project power on their firms' behalf. As long ago as the turn of the twentieth century, emerging economy host governments tried with the Calvo Doctrine to forbid home governments from interfering on

[19] "Declaration of the Occupation of New York City," Occupy Wall Street Movement (nycga.net).
[20] Cardoso and Faletto 1979, Evans 1979, Van Harten 2005. This view is associated with the *dependencia* school.
[21] Mosley 2011, Locke 2012. See also Mosley and Uno 2007.
[22] Kono 2006, Oye and Wellhausen 2009, Vogel 1997, Singer 2007, Mosley 2011, Drezner 2001.
[23] Hirst and Thompson 1999.

behalf of their nationals' firms abroad. Although host governments tried to codify it many times, the Calvo Doctrine never made it into law (Chapter 7). Home governments still can and do use tools available to them to fight their nationals' contract disputes. Even in an era when many think multinational corporations are their own international actors, we will see that home governments remain relevant and powerful.

Whether or not nationality matters to foreign firms in all times and places is an open question. But in the extreme moment of a threat to a firm's contract sanctity, nationality is a source of information for firms and a means of accessing the power of home governments. Co-nationals share a shield protecting contract sanctity. When breach occurs, foreign firms do not form a united front, nor is it every firm for itself. Co-national action rises to the fore and – sometimes – can be sufficient to deter government breach of contract.

"ROOM TO MOVE"

Given variation in the risks to contract sanctity across different national investor groups, a counterintuitive result emerges at the level of the economy as a whole: greater national diversity among a host country's foreign firms opens permissive space for a host government to break contracts. This permissive space is the result of a simple dynamic among the nationalities of foreign firms in a host country. When a government is host to a greater diversity of national investor groups, any one group's decision to divert FDI has relatively less influence on the host government's current and future access to capital. Additionally, home country diplomats are less likely to have leverage over the treatment of their firms when those firms' continued presence matters less to the host government's capital access.[24] Diplomats are unlikely to expend political capital on a broken contract they have a low likelihood of repairing. When the proportion of co-national actors taking costly actions toward the host government in response to a given breach shrinks too far, breach and FDI can co-exist. This co-existence generates permissive space that is best characterized in Layna Mosley's terms – as "room to move."[25]

Such room to move, on something as extreme as foreign firms' property rights, shows that governments continue to have real flexibility even under conditions of economic globalization. Wider integration with more national groups of foreign firms gives host governments the power to prioritize other interests over foreign firms' property rights. A major scholar of economic globalization, Dani Rodrik, argues otherwise. In his "globalization paradox," Rodrik writes that governments cannot simultaneously prioritize foreign

[24] Access to FDI is not only about capital, but also about the taxes, technology, employment, and spillovers that may accompany it. However, I will use "capital access" as a shorthand in this book.

[25] Mosley 2000, 2003, 2005.

economic actors' preferences, pursue democracy, and exercise national determination.[26] At best, governments can choose two out of three. If emerging-economy governments choose deep economic integration, the "paradox" hits hardest: governments must give up democracy or sovereignty. In Rodrik's estimation, deep integration with a great variety of foreign investors must correlate with weaker democracy and curtailed sovereignty, as acting against foreign property would cut a country off from the international economy. In a direct challenge to this logic, I identify space in which governments retain access to some (though not all) sources of FDI while exercising sovereignty through breach of contract with foreign firms. Whether host governments choose to use their "room to move" on foreign firms' property rights to engage in democratic practices is, however, up to them.

WHY GOVERNMENTS BREAK CONTRACTS

This book is about the permissive space that host governments have to break contracts with certain nationalities without incurring penalties from other nationalities. Lurking behind this is the following question: why do governments break contracts with foreign firms? As with all contracts, uncertainty mars the explicit contracts governments enter into with foreign firms as well as governments' implicit commitments to respect and protect foreign firms' property rights. Add to this initial uncertainty the inevitable changes to circumstances that come with time, and a government may decide that it would be better if a given contract were called off. Incentives to renege on commitments are not unique to governments, of course. Whether we speak of state-level privatizations or individual consumers' cell phone contracts, the temptations to breach are relatively constant and universal – and this book takes them as such.

We can, however, get a handle on the kinds of motivations host governments have in breaking contracts. Governments, and the individuals and bureaucracies of which they are made, face incentives to breach in order to derive benefits from positions of authority as well as to remain in power. Governments can use breach to privilege one nationality of foreign investor over another, to create unfair domestic market players, or to change the status of certain investments. Breaking contracts in these ways can help governments to achieve a plethora of goals. Empirically, these goals tend to fall into four categories: enhancing revenue; responding to the particular circumstances of an asset or sector; targeting firms in order to enact foreign policy; and catering to domestic interests.

Foreign firms are some of the wealthiest actors in emerging economies, and their ready access to parent-firm resources can make them attractive targets with which governments can break tax rate commitments, as we will see in Chapter 5 on foreign firms' experiences in Ukraine. Governments can also enhance revenue by stopping payment on contracts; countries like Togo and Bolivia have done

[26] Rodrik 2011.

this with energy and water concessions. Asset- or sector-specific breach can enhance revenue but tends to be framed in terms of issues of fairness between foreign and domestic actors. Oil-rich nations, for example, have forced contract renegotiations in the sector in order to capture unexpected profits. At other times, asset-specific breach is about re-regulation after a contract is in place, in what is known as "regulatory taking." For example, countries including Tanzania and Mexico have broken water and sewage service contracts, citing failures in service quality. As we will see in Chapter 6, Romania effectively revoked the permits of a Canadian mining firm on environmental grounds.

Another category of breach is more explicitly bilaterally motivated, as governments can use breach to enact foreign policy. Such motives likely stood behind the Ukrainian government's refusal to pay the gas prices contracted with Russia's Gazprom in disputes that have spanned the 2000s. One may also imagine foreign policy motivations behind the preferences (sometimes) given to Russians over Estonians in Ukraine. Finally, a variety of motivations fall into the category of breach that seeks to satisfy domestic interests. Public opinion can indeed favor breach. For example, support in Eastern Europe for extracting additional value from privatized firms is widespread, and many of these firms have foreign ownership.[27] Breach can be important in pursuit of votes: in the late 2000s, Slovakian political parties ran on the platform of breaking energy contracts with German and Italian providers.

Government actors may break contracts for corrupt reasons; certainly, this is an accusation foreign investors often level at governments. Then again, what might appear as another sort of motivation, corrupt or otherwise, may be simply the government's attempt to get out of a commitment that seems unwise ex post. Cases of government breach of contract, which appear throughout this book, tend to be backed by multiple and fluid motivations that are aimed at achieving one or more of these goals. The important takeaway is that these categories of motivations are incredibly broad. Understanding government motivations for breaking contracts is a rich area of research to which a variety of literatures in international and comparative political economy can speak. In this book, however, I tackle the question: given so many incentives to breach, how can we know whether the government in fact has the space to breach? The diversity of FDI nationalities helps to determine whether governments face low enough costs to breach in the ways they desire. I find that "room to move" on foreign firms' property rights exists, and this room is intimately tied to firm nationality.

BREACH IN ARGENTINA

Foreign firms in Argentina provide an example of co-national coordination and apparent cross-national indifference. Argentina has become infamous for breaking contracts with foreign investors thanks to its 2001–2002 default

[27] Wellhausen 2010; Denisova et al. 2009, 2012.

and surrounding financial crisis. The shock of the default and currency devaluation led the Argentinian government to stop paying its bills.[28] By 2012, Argentina was years overdue in paying legal awards of US$300 million to two American firms.[29] President Obama linked the issue to international trade and suspended American trade benefits for Argentina in retaliation. The Argentinian president complained, "not even one of our lemons can enter their market."[30] But other home governments and other national groups of investors in Argentina did not publicly back American actions.

Months later in 2012, the Argentinian government nationalized a Spanish-owned firm that was the dominant energy firm in Argentina. In retaliation, Spain linked breach to trade and stopped importing Argentinian biodiesel, which had earned Argentinian exporters approximately US$1 billion in 2011.[31] But neither the United States nor Spain publicly linked their national firms' expropriations to the other. Moreover, Spain promised that the European Union would undertake "very clear interventions" on Spain's behalf, but the EU issued only a non-binding resolution.[32] An anonymous EU official summed up the EU's inaction: "This is a matter of investment and expropriation which is dealt with by the bilateral treaty."[33] In fact, just months after nationalizing the Spanish investment, Argentina and the nationalized energy firm held a roadshow searching for strategic investors from the UK and elsewhere.[34] Argentina has faced bilateral rather than broader diplomatic punishments for its broken contracts, even when it appeared logical for US and Spanish interests, not to mention European interests, to coordinate more broadly.[35]

The long-term impact of Argentina's actions remains unclear.[36] Commentators have warned the Argentinian government with an ominous refrain: expropriating

[28] For excellent discussion of just how much was at stake in the crisis, see Tomz (2007) and Blustein (2005).

[29] The overdue payments were from awards in international investment arbitrations (IAs). "Azurix calls for action against recalcitrant Argentina," *Global Arbitration Review*, 29 September 2010.

[30] "We Can't Even Manage to Send a Lemon to the US, CFK," *Buenos Aries Herald*, 26 March 2012. Reprinted at bilaterals.org.

[31] Minder, Raphael, "Spain Stings Argentina over Oil Company Nationalization," *The New York Times*: 20 April 2012. "Biodiesel Trade to be Affected by Argentine Oil Company Takeover," *Bridges Trade BioRes*, Vol. 12(8), 25 April 2012. Reprinted by the International Centre for Trade and Sustainable Development (ictsd.org).

[32] Spain called for international organizations like the World Bank, IMF, and WTO to push Argentina "to return [to] the path of international rule of law," but those organizations did not take public action. Quoted in "Biodiesel."

[33] Quoted in "Biodiesel."

[34] Trotman, Andrew, "Argentina seeks UK funds for expropriated oil group YPF," *The Telegraph* 14 September 2012.

[35] EU countries – as well as Latin American countries and the United States – have taken joint action against Argentinian tariffs. This is a different, shared issue, in contrast to contract sanctity, which is a nationality-specific issue.

[36] In 2014, the Spanish firm Repsol accepted US$5 billion in Argentinian government bonds to compensate for the nationalization. This was less than half of the amount they demanded in

foreign assets risks "cutting a country off from the main flows of credit, investment, and commerce."[37] The nationality shield theory, however, accounts for the permissive circumstances in which Argentina has taken strong action against foreign firms. As one of the most attractive South American markets (despite its macroeconomic troubles), Argentina has been host to a great variety of FDI nationalities throughout much of the 2000s and into the 2010s. With a great diversity of investors, Argentina has been able to trade off one nationality's contract sanctity for continued investment from others. Thus, Argentina has been able to breach some contracts while still maintaining (albeit not maximizing) capital access.

PLAN OF THE BOOK

In Chapter 2, I define and explain the phenomenon of government breach of contract, discussing what it is to break a contract, why governments might want to break contracts, and the variety of ways in which contracts are broken. With this necessary background, the remainder of the book focuses on the constraints under which governments are able to act on incentives to breach.

Chapter 3 lays out the nationality shield theory and considers its observable implications. Economic globalization generates pressure for emerging-economy host governments to protect foreign firms' property rights, but foreign firms do not act as a monolithic bloc to enforce their property rights. Capital does not uniformly exit the host country following a government breach of contract, nor do foreign firms uniformly protest breach. When foreign firms have different national origins, one firm's broken contract is less likely to motivate the other to exit or protest. As FDI is spread over more national groups, the host government has increasing space to breach contracts and sacrifice FDI from one national group without threatening its broader access to current or future FDI. An environment of higher FDI national diversity makes foreign firms less effective at enforcing their own contracts and, as a result, increases the likelihood of government breach of contract in the economy as a whole. Host governments gain the space and autonomy to act against foreign firms' interests. The counterintuitive implication is that the presence of a greater variety of investor nationalities in the host economy undermines, rather than reinforces, foreign firm property rights.

In Chapter 4, I conduct quantitative tests of the effect of FDI national diversity on the likelihood of government breach of contract. First, I show that a novel measure of FDI national diversity is positively associated with both investor perceptions about breach and the incidence of breach, using national-level data. I then provide evidence from firm surveys that firms in countries with

cash in international investment arbitration. For analysis of the politics of expropriation compensation, see Johnston (2013).

[37] Lampreia, Luiz, "Argentina the Outcast," *Project Syndicate: A World of Ideas*: 4 May 2012. Lampreia was formerly Brazil's Minister for Foreign Relations (1995–2001).

more FDI national diversity report a greater incidence of breach of contract, as measured by government non-payment. Finally, I use dyadic FDI and operationalize breach as the instances in which foreign firms have, as a last resort, committed resources to publicly sue governments. I find that annual FDI flows in a directed dyad decrease significantly when co-nationals have sued in the previous several years, but, as hypothesized, firms do not significantly change their investment behavior when a firm of another nationality sues. I also extend the analyses to explore the effects of different kinds of BITs on breach; how FDI national diversity relates to government motivations for breach; the effects of FDI national diversity on firms in different industries; and how the size of a nationality's investment in a host country conditions relationships.

Chapters 5 and 6 use case studies to trace the role and effectiveness of diplomacy as well as collective action in deterring breach under different levels of FDI national diversity. Qualitative evidence is supported by 161 interviews conducted between 2009 and 2013 with local heads of foreign firms, government officials, foreign investor associations, legal professionals, and multilateral organizations in Ukraine, Moldova, and Romania as well as Azerbaijan, Russia, the United States, and Germany.[38] Case studies are drawn from Ukraine, Moldova, and Romania, which are useful settings in which to test the nationality shield theory. These countries do not have the market size or natural resource endowment that may give some host governments special leverage over foreign firms.[39] They vary in levels of economic development, providing an opportunity to demonstrate that breach of contract is not only a phenomenon in relatively poorer or richer countries. And, their shared geography and history help to constrain the set of foreign direct investors either currently investing or interested in investing in the region (*Case Studies: Methodology*).

Over-time variation in the nationality diversity of the investor community in Ukraine provides leverage in Chapter 5 to explain both the presence and absence of firm and diplomatic efforts that successfully deterred breach. In Chapter 6, I compare the experience of foreign firms and diplomats in Moldova and Romania, two countries that have similar levels of dependence on FDI. Moldova is the poorest country in Europe with complex ties to Russia and its Soviet past; Romania has joined the European Union. Nevertheless, low FDI national diversity in Moldova contributes to effective co-national lobbying and the low incidence of breach there, while high FDI national diversity in Romania coexists with less successful lobbying by co-national actors and numerous examples of high-profile contract breach.

[38] Interviews on cases in Ukraine, Moldova, and Romania were also conducted in Germany and the United States. All interviewees were promised confidentiality. The nationality, industry, and host country of foreign firms have been provided wherever possible to do so without violating confidentiality. See Case Studies: Methodology for more information on the interview strategy.

[39] Rudra and Jensen 2011.

In Chapter 7, I situate modern government breach of contract in historical context. Since the early twentieth century, various international institutions have tried and failed to codify foreign-firm rights and host-government responsibilities with respect to FDI in emerging economies. After repeated failures at multilateral treaties, it has fallen to BITs to codify investment protection. Ironically, while providing some protection to property rights, these treaties have increased the visibility of variegated forms of breach of contract around the emerging world. I trace the backstory of the book's theory by demonstrating growth over time in the key form of foreign-firm variation under consideration: nationality.

In the final chapter, I consider what the nationality shield theory and evidence mean for our expectations about the link between economic integration and rule of law. The book's explanation as to why host governments sometimes breach contracts with foreign firms exposes a substantial flaw in what has been accepted as a basic effect of economic globalization. We should not always expect FDI to be doing the work of increasing government respect for rule of law with regard to foreign direct investors themselves. In fact, deeper global integration, via exposure to a greater national diversity of foreign firms, can even undermine government commitments to contract sanctity and rule of law.

2

When Governments Break Contracts

Foreign direct investors build new factories, enter into ventures with domestic firms, buy "brownfield" property, and own office space in host countries. Direct investors operating in the host government's jurisdiction rely on the basic contract that the state will not interfere with their tangible physical property, intellectual property, or money-as-property. Host-government contracts with foreign firms take a variety of forms. Governments are the direct counterparty on privatizations; they license foreign firms to run infrastructure and natural resource concessions; they enter into joint ventures with foreign firms; and they commit to regulatory standards and tax rates in the terms of investment agreements. Moreover, once governments allow foreign firms to enter the domestic economy, they make a myriad of more or less formal commitments to ensure foreign firms' ability to operate. I label this suite of explicit and implicit commitments to protect foreign firms' property rights "contracts" between host governments and foreign firms.

Why do governments sometimes break contracts and sometimes honor them? The benefits of foreign direct investment (FDI) are great enough that governments around the world compete to attract and grow FDI. But, as for any counterparty to an agreement, breach of contract by the government has been and continues to be a means for actors to capitalize on changed circumstances despite pre-existing commitments. This chapter discusses why governments seek out FDI and goes on to outline why governments might benefit from breaking contracts with foreign firms once invested. I then present data on the many ways in which governments break contracts – everything from nationalization through "creeping" expropriation, regulatory taking, violations of international treaty commitments, and more. Given government motives to breach and evidence that governments do at times breach contracts (at least from a foreign investor's point of view), I set the stage for a firm-level explanation that accounts for the space governments have to sometimes break contracts with foreign firms.

FOREIGN DIRECT INVESTMENT

Firms undertaking foreign direct investment (FDI) have long been thought to have aces in their pockets when it comes to ensuring protection of their property rights: host governments want the development contributions typical of FDI, especially as compared to other international capital flows. The International Monetary Fund officially defines FDI as a "lasting interest" of 10 percent or more in a foreign enterprise, which "implies the existence of a long-term relationship between the direct investor and the direct investment enterprise, and a significant degree of influence by the investor on the management of the enterprise."[1] Foreign direct investors thus typically have long time horizons, taking management positions in their investments. In this way, foreign firms not only provide capital to host economies but can also transmit management know-how and technology. Transmission mechanisms may be formal, such as licensing agreements; joint ventures with local partners, whether state-owned or private; or collaborations between foreign and local workers employed within the multinational and its local affiliate.[2] By introducing both codified and tacit knowledge into the host economy, these relationships can facilitate local learning. Other transmission mechanisms are more informal. For example, development officials hope that multinational corporations enhance domestic productivity as their methods and standards spill over to local suppliers, to domestic firms consuming the multinational's product or engaging in downstream activities, and to other domestic firms in the same industry.

Foreign direct investors typically intend their capital to be used in one or more of several ways: to serve the domestic markets of the foreign countries in which they invest, to use foreign countries as export platforms, to take advantage of labor and capital inputs available there, or to exploit natural resources found in particular geographies in the world.[3] Foreign firms with any of these motivations can make positive contributions to local development. For example, firms that use operations as export platforms can increase a host country's export volume, likely beyond what domestic firms would have done in their absence. Firms that exploit natural resources often do so with levels of efficiency otherwise unavailable domestically. Sometimes foreign firms' contributions add up to increases in local standards of living or a host economy's overall economic growth.[4] Not to be forgotten, foreign firms are key sources of tax revenue, as they are often among the richest players in an emerging economy.

[1] "Definition of Foreign Direct Investment (FDI) Terms." 2004. IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics, Direct Investment Technical Expert Group. Issue Paper 20. Prepared by Art Ridgeway, Statistics Canada.

[2] Blomström and Kokko 1995.

[3] Dunning 1980.

[4] E.g., Farrell et al. 2004.

Host governments have found the potential benefits of FDI good enough to fight for. President Atatürk of Turkey expressed respect for foreign firms already in 1923, saying, "Do not suppose that we envy foreign capital. No, our country is extensive. We require great effort and great capital. Therefore, we are always prepared to provide the necessary security to foreign capital on the condition that its profits be regulated by law."[5] Since the 1980s, the easing of cross-border regulations and concerted investment attraction activities in nearly every country in the world show that these sentiments are alive and well. China treats foreign firms with kid gloves because the country's own political economy would be dysfunctional in their absence.[6] The Czech Republic promptly paid a US$350 million settlement to a foreign firm "in order to safeguard the nation's reputation abroad," according to the foreign minister.[7] Nearly all countries in the world (and many regions) have Investment Promotion Agencies (IPAs) tasked with enticing FDI, a cornerstone of many countries' development strategies. At the same time, the rise of the Internet, advances in logistics, lower oil prices, deverticalization, the break-up of supply chains, and other advances in technology and business organization have encouraged firms to seek new sources of revenue via foreign affiliates. This combination of interest from potential host countries and the growth of potential investors has led to rapid increases in FDI. By the 2000s, FDI accounted for some two-thirds of world foreign investment flows. In 2011, the accumulated stock of FDI in the world surpassed US$20 trillion. This value is nearly four times the US$5 trillion in world FDI in 2000 and twenty-nine times the US$700 million in 1980. Some 82,000 multinational corporations, with over 800,000 affiliates, undertake FDI. Foreign affiliates employ some 69 million workers, responsible for US$7 trillion in value added.[8] FDI in emerging economies is a growing part of this picture. In 2011, accumulated FDI stock in emerging economies reached US$7.3 trillion, or 36 percent of world FDI stock.[9]

For their part, foreign investors offer a set of carrots and sticks that many believe can help establish informal property-rights enforcement. At its best, FDI provides jobs, technology, export growth, tax revenue, and other contributions to development in capital-scarce emerging economies. Now, the consistency with which FDI provides these hoped-for developmental goodies is up for debate.[10] But to expropriate foreign firms would be to severely undercut the probability of getting such benefits. Why invest when the security of investments and the returns from investments are in doubt?

[5] Robinson 1963: 106. Quoted in Lipson 1985: 72.
[6] Huang 2003.
[7] Kerner 2009: 78.
[8] UNCTAD World Investment Report: Toward a New Generation of Investment Policies (2012): xi.
[9] UNCTADStat, accessed May 2013. Emerging economy FDI includes FDI into "developing countries" and "transition countries."
[10] See Moran et al. (2005) for excellent and nuanced analyses of the developmental effects of FDI.

WHY GOVERNMENTS BREAK CONTRACTS

Access to and the accumulation of FDI has been important to emerging economies and their governments' development strategies. But, like any counterparty, breach of contract has been and continues to be a means for actors to capitalize on changed circumstances despite pre-existing commitments. Host governments and their constituent parts are interested in remaining in office and otherwise deriving benefits from their positions of authority. In the pursuit of those interests, government actors might find themselves facing short-term motivations that outweigh broader long-term interests in capital access.[11] What do such short-term motivations look like? The basic conceit of this book is that the temptations to breach are many. With so many reasons to break contracts, I focus on explaining the conditions under which governments find permissive space to do so. Yet given all the benefits that FDI can confer on a host economy, it is worth spelling out the sorts of temptations that can tip the scales toward breach. Based on analysis of the kinds of motivations governments offer (or are accused of) in legal communiqués, as well as conversations with the heads of multinational subsidiaries and government officials in Eastern Europe, I offer four broad motivations for government breach of contract with foreign firms: enhancing revenue; responding to the particular circumstances of an asset or sector; achieving foreign policy goals; and catering to domestic interests.[12] While corruption certainly has a role to play, these kinds of motivations for breach suggest that unlawfully violating contracts with foreign firms may sometimes have normatively ambiguous or even positive implications.[13]

First, some governments have used breach of contract with foreign firms as a means to supplement budgets in hard times. Foreign firms are often the wealthiest firms in an emerging economy, with parent company resources on which to draw. Breach in the form of withholding payments can provide a third budgeting option apart from cutting spending or raising taxes from domestic actors. This kind of breach has been particularly visible in times of financial crisis, when governments face dual incentives. On one hand, upholding commitments to foreign firms may help a government to maintain access to long-term capital

[11] Along these lines, Albertus and Menaldo (2012) find that large-scale expropriation helped Latin American dictators survive in power. Their analysis includes expropriations of domestic and foreign-owned assets.

[12] In Kindleberger's words, arguments against FDI rise from the "peasant, the populist, the mercantilist, or the nationalist which each of us harbors in his breast." Kindleberger, Charles, 1969. *Six Lectures on Direct Investment*, New Haven, CT: Yale University Press, 145. Quoted in Kobrin 1987: 610.

[13] I use the term "unlawful" rather than "illegal" to characterize government breach of contract, as breach may or may not clearly violate a written set of domestic or international laws. However, from the point of view of the foreign firm, government actions that reduce the value of foreign-owned property outside the scope of an original contract and/or in a discriminatory way are unlawful.

or even short-term multilateral capital. In a case discussed in Chapter 5, Ukraine had for some time withheld repayment of Value Added Tax (VAT) to multinational exporters, allowing the government to effectively increase tax rates on some foreign firms and, in the process, remain solvent. But when the worldwide financial crisis hit Ukraine in the late 2000s, the IMF pressured Ukraine to repay VAT as a condition for accessing IMF support. On the other hand, breach may be at least domestically justified as a necessary step to deal with potential financial disaster. Argentina infamously withheld and canceled payments to many foreign firms in the midst of its 2001–2002 default and surrounding financial crisis. Indeed, Argentina has argued that its economic crisis constituted a valid justification for breach, as the government would have faced deeper and broader deficits and crises had it honored its contracts. What is more, breach allowed the government a way to deal with mass protests, hunger, and hardship among the Argentinian population. Financial crisis led Cyprus, too, in 2013 to choose to freeze and expropriate bank deposits, an action that mainly affected investors from Greece and Russia, even as it imposed hardship on the domestic population. Quickly thereafter, the Cypriot government faced protests and threats of litigation from Greek and Russian firms, claiming these expropriations disproportionately and thus unlawfully discriminated against them.

Outside of times of crisis, governments have also violated contracts with foreign firms and benefited from increased revenues or the avoidance of liabilities. The government in Togo had by 2006 accrued years of payment arrears to a French-owned electricity concession, effectively trading its commitment to pay for electricity for the freedom to spend those dedicated government funds elsewhere.[14] A firm from the United Arab Emirates has protested that after the Mubarak government fell in Egypt, it was asked to pay the new Egyptian government in kind and in cash to offset the shortfall against a revised assessment of their land value.[15] Governments have also declined to pay even small amounts, for example, when Russia refused to settle a debt for some US$300,000 in equipment that an Italian firm supplied to a previously Soviet trading enterprise.[16] Foreign firms are not constituents of the host government and they are relatively rich, especially in emerging economies. The temptations to raise money at their expense are real, in or out of crisis.

Perhaps the most popularly recognized set of motivations for government breach of contract are sector-specific. Often, sectoral expropriations come along with economic nationalist ideologies. Beliefs about the sovereign right of a host country to profit from its natural resources, articulated by less developed countries in the United Nations in the 1970s and still present today, have spurred dissatisfaction with the fairness of foreign contracts (Chapter 7). Such ideologies have

[14] As reported in *Togo Electricite v. Republic of Togo (ICSID CONC/05/1).*

[15] As reported in *Hussain Sajwani, Damac Park Avenue for Real Estate Development S.A.E.*, and *Damac Gamsha Bay for Development S.A.E. v. Arab Republic of Egypt (ICSID ARB/11/16).*

[16] As reported in *Cesare Galabini SpA v. Russian Federation (UNCITRAL 2009).*

 https://doi.org/10.1017/CBO9781316014547.003

often made investments in natural resources ready targets. Since 1990, governments in Venezuela, Ecuador, Kazakhstan, the Democratic Republic of Congo, Mongolia, Mali, Ghana, Burkina Faso, and elsewhere have forced renegotiation of contracts or have expropriated foreign-owned assets in resource industries. Professed motivations include dissatisfaction with foreign management when commodity prices are down.[17] In times of commodity price booms, governments may face particular pressure to redistribute new wealth. As a result, more publicly accountable democratic governments may in fact be more likely to expropriate than autocratic governments under those same conditions.[18] Certainly major expropriations in oil and natural gas, infrastructure, and the like provide fodder for the ideological and material interests of some government actors.

Motivations for breach can also be asset-specific, beyond sector-based motivations. Often, such breaches of contract manifest themselves as a government simply getting out of what it sees as a bad deal. In Lithuania, for example, Vilnus issued a tender for a new parking system and awarded the contract to a Norwegian firm. After much back and forth over double-decker parking garages and credit-card-reading parking meters, Vilnus broke the contract and subsequently faced litigation from the Norwegian firm.[19] The terms of a particular agreement over a particular set of assets thus provided motivation for government breach of contract, without a clear ideological or redistributive overlay.

Government breach of contract may also have less banal motivations, such as when breach is a means to achieve foreign policy goals. The bilateral determinants of contract risks, described in detail in Chapter 3, can directly inspire government targets for breach. For example, host governments can use breach of contract as a means of conducting diplomacy through issue linkage. Oye calls this kind of issue linkage "bracketing" – when diplomats threaten that inaction on one issue, in this case government breach of contract with foreign firm(s) of that nationality, will trigger punishments in another issue area.[20] For example, in the 1980s, a textile quota reduction by the United Kingdom spurred Indonesia to impose an "embargo" on a British firm that had been given a contract to construct a large chemical plant.[21] Certainly, in times of conflict a belligerent's property is expropriated; Georgia, for example, took over Russian-owned property and largely forbade the entry of new Russian investors during the 2000s. Incidentally, conflict can inadvertently cause a breach of contract: in Sri Lanka, the government is thought to have used expropriation to target opposition supporters, but a Hilton hotel and other Western-owned assets numbered among those expropriated.

[17] Guriev et al. 2011.

[18] Duncan 2006. See also Guriev et al. 2011. Greater compliance in autocracies also follows the finding in Reinhardt (2000) that, contrary to previous literature, democracies participate in more trade disputes in the GATT/WTO and resolve them less cooperatively.

[19] As reported in *ParkeringsCompagniet AS v. Republic of Lithuania (ICSID ARB/05/8)*.

[20] Oye 1992; Lohmann 1997, Davis 2004.

[21] Stopford et al. 1991.

Foreign policy interests can overlap with asset-specific interests when a particular nationality's ownership threatens national security. Chapter 5 relates the case of a Norwegian firm with which the Ukrainian government was eager to keep its contract so as to prevent an effective Russian takeover of the telecommunications industry. In Lithuania in 2006, the government prevented a Russian state-owned enterprise from recovering an oil refinery that had been owned by the dismembered oil firm Yukos. The Russian state had authorized the recovery as compensation for Yukos's unpaid Russian back taxes. The Lithuanian government declared that Russian ownership of the oil refinery – the biggest in the Baltic region and one of Lithuania's major assets – would be contrary to Lithuania's security interests. Lithuania quickly sold the refinery to a Polish firm. From the Russian firm's and the Russian government's points of view, rightful Russian assets were expropriated. From Lithuania's point of view, however, the breach of contract supported the country's foreign policy interests by growing the presence of Polish investors at the expense of Russian investors. The assertion of power over Russia buoyed domestic support for the Lithuanian government, and it was viewed positively by the European Union.[22]

Breach of contract can satisfy domestic interests in a variety of ways. For convenience, this book often refers to a "host government" as a singular entity. Of course, host governments are not unitary actors, and internal politics contributes to decision-making around contract sanctity. The benefits from breach may be unevenly distributed across political parties, bureaucracies, or other parts of the host government. Different actors in the host government may also be more or less sensitive to the costs of foregone capital and any diplomatic pressure exercised on a targeted firm's behalf. As demonstrated by the case studies in Chapters 5 and 6, the divisions created by these asymmetries can help or hurt co-national foreign firms and their advocates in their efforts to deter breach.

In general, FDI can produce social tensions that result in significant industrial conflicts.[23] For example, Fails finds that when the executive is highly constrained, income inequality increases the risk of expropriation, thanks to its redistributive possibilities.[24] In general, government actors can take advantage of social tensions to gain domestic approval at foreign firms' expense. In the "water war" in Bolivia in 2005, Evo Morales (later to become president) capitalized on local and national protests when he revoked the American firm Bechtel's contract in the town of Cochabamba. The contract was revoked because Bechtel increased rates on water and sewage services and suspended

[22] For a retelling of the story, see Kramer, Andrew, "Lithuanians are given a taste of how Russia plays the oil game," *New York Times*, 28 October 2006.

[23] Robertson and Teitelbaum 2011. Though, as Ancelovici argues, economic explanations do not provide full accounts of the "magnitude, form of the constituency, and ideology of the opposition to globalization."Ancelovici 2002: 428.

[24] Fails 2012.

services to customers in arrears.[25] Energy pricing is another issue area in which governments often clash with foreign firms over levels of redistribution. In Slovakia, for example, the party in power threatened in 2006 to expropriate an Italian electricity producer, accusing it of overcharging its Slovakian customers. In 2008, the Slovakian government threatened the German and French owners of the national natural gas monopoly with renationalization if they increased prices. Invoking breach reinforced the government's credentials with the domestic population on the much-reviled issue of energy price increases, even as it angered international observers.[26] In the end, the Slovakian government gained foreign firms' cooperation over energy price controls and got re-elected – without following through on expropriation threats.

Winners and losers from privatizations have not always emerged from fair processes, and Frye points out that property rights are politicized when the public views them as illegitimate. This leads to demands for the state to step in and reallocate.[27] The view that privatization, including corrupt or non-transparent privatization, has been privileged over other social and nationalistic goals is one point of dissatisfaction that democratic institutions allow into national discourse. In Ukraine after the 2004 Orange Revolution, one party in the coalition government used notions of inequality to advocate the nationalization and reprivatization of unspecified privatized assets; this threatened the property of foreign (and domestic) firms across the country. The reprivatization campaign was supported by an overwhelming majority of Ukrainian citizens, buoying the party leader's standing at least for a time (Chapter 5). As of 2006, in Bosnia and Herzegovina 8 percent of 1100 large-scale privatization contracts were terminated.[28] By 2009, 1600 Romanian privatizations were abrogated, including 350 with foreign owners.[29] *Ataka*, the Bulgarian nationalist party whose platform includes the position that "privatization contracts are subject to revision," won 9 percent in the 2005 legislative elections and 12 percent in the 2009 European Parliament elections, making even bigger gains in 2013. *Jobbik*, a similar party in Hungary, pledged in their 2010 Manifesto to "initiate legislation designed to protect state assets, which will result in those seeking to disown the nation of its property punishments of up to life imprisonment." Support for *Jobbik*, in various kinds of elections, has grown from 2.2 percent in 2006 to 16.7 percent in 2010.[30] The presence of such party platforms undoubtedly raises the salience and probability of privatization revision,

[25] Forero, Juan, "Who Will Bring Water to the Bolivian Poor?" *New York Times*, 15 December 2005.
[26] Malov and Ucen 2009.
[27] Frye 2006; Denisova et al. 2009, 2012.
[28] Personal communication with Enes Ganić, Director of the Agency for Privatization in the Federation BiH (9 October 2006).
[29] Interview, Romanian market analyst, Romania, 2009.
[30] Elections for Hungarian Parliament in 2006 and 2010.

although much of the debate concerns redistributing the benefits of privatization rather than returning to a state-owned society.[31]

Another means of satisfying domestic interests through breach is "regulatory taking," when a government's extra-contractual devaluing of foreign property accomplishes what amounts to a targeted and not economy-wide regulatory change. Breach can allow governments to re-regulate after having committed to regulatory standards under conditions of uncertainty or asymmetric information, when domestic demand for regulation was lower, or when regulatory norms were otherwise different. For example, in a controversial lawsuit brought under the Chapter 11 investor protection portion of the North American Free Trade Agreement (NAFTA), an American firm argued that changed Mexican regulations on hazardous waste disposal unlawfully prevented the American firm from operating.[32] In this case, arguments about the Mexican government's right to regulate were dismissed and the American firm won the suit. Some observers are disappointed in legal decisions like this one that label regulatory taking as illegitimate government breach of contract.[33] For example, re-regulation through breach can align with governments' commitments to international organizations. In Uruguay, the tobacco firm Philip Morris has filed suit under BIT protections in response to legislation enacting some of the world's most stringent tobacco packaging and branding laws. Philip Morris argues that the "plain packaging" legislation devalues their intellectual property in favor of lesser-recognized local brands.[34] The World Health Organization, for its part, supports Uruguay.[35] The Australian government, too, has since enacted parallel laws and is facing analogous suits from Philip Morris Hong Kong. Chapter 6 presents a case in Romania in which local and international environmental groups laud the government's effective expropriation of a Canadian-owned gold mine, an action that has received the unofficial approval of the European Union, too. In situations of regulatory taking, governments sometimes get the backing of international actors when at the same time satisfying domestic demands for improved health, safety, and other regulatory standards.

Of course, corruption is a key means by which government officials can use breach to benefit from their authority – satisfying a very particular set of domestic interests. Indeed, accusations of government corruption often figure prominently in foreign investors' arguments at international legal proceedings around breach. One might posit that broad-scale nationalization, involving investors of many nationalities, threatens a country's capital access to the

[31] Wellhausen 2010; Denisova et al. 2009, 2012.

[32] *Metalclad Corporation v. United Mexican States (ARB[AF]/91/1)*. Brought in 1997; award rendered in 2000.

[33] See, for example, the non-governmental organization the Network for Justice in Global Investment.

[34] *Philip Morris Brand v. Oriental Republic of Uruguay (ICSID ARB/10/7)*. Brought in 2010.

[35] See, for example: Wilson, Duff, "Cigarette Giants in Global Fight on Tighter Rules," *New York Times*, 13 November 2010.

point where corruption and executive rent-seeking must play a motivating role. Hugo Chavez's government in Venezuela was the most headline-grabbing example. Detractors of Chavez's expropriation campaigns throughout the 2000s and into the 2010s saw his actions as an abuse of power. Nevertheless, even the extreme actions of the Chavez government likely had multiple motivations beyond corruption. Indeed, these motivations fall into the categories outlined here: the Chavez government nationalized some of the most lucrative assets in the country; it initially targeted high-profile natural resource firms; it used expropriations of American assets as a platform for anti-US rhetoric; and it used nationalistic rhetoric about protecting and prioritizing Venezuelans.

Understanding the depth, breadth, and effects of particular motivations for breach is a rich area for future research. Some conclusions can be drawn from the points made here, however. One is that both small and large investors can face breach of contract. For example, a government may target the largest investors to raise revenues or target the smallest share to achieve corrupt motives with less disruption. Or, motives for breach may be orthogonal to the size of the investor. Neither must host government motives correlate with the size of FDI stock in an emerging-economy host country. More FDI in aggregate does not in itself suggest that all motives for breach will be washed away or, alternatively, become more prominent. Rather, what we can conclude from this plethora of motives is that host governments need not be capital-seeking above all else. When given the opportunity, host governments have reason to exercise their sovereign power over foreign firms in favor of other goals.

A final point is necessary about what is a common refrain in investor-host-government disputes: it was the other side's fault. If a foreign firm does not adhere to the terms of its contract, the host government responds in kind. Of course, fault is rarely, if ever, a clear-cut issue. Regardless, the legitimacy of a contract breach is not under consideration here. The label of "government breach of contract" in this book is based on foreign firms' understanding of government actions that unlawfully affect the value of their property. When a government allows an event understood to be a breach to occur, the implication is that the government stands behind its action or is playing a high-stakes game of chicken with the foreign firm. In either case, the government's actions generate doubt around contract sanctity that contributes to an inhospitable investment environment. Whatever the ultimate legality of any particular breach, the costs of other current and potential investors responding adversely to breach can, under the right conditions, deter host governments from undertaking what foreign firms see as breach of contract.

HOW GOVERNMENTS BREAK CONTRACTS

Today, the opportunity costs of foregoing foreign capital altogether have become too high for all but the most isolationist regimes. Accordingly, in the period since 1990, breach has only rarely been about a rejection of foreign

 https://doi.org/10.1017/CBO9781316014547.003

ownership per se. However, just as governments make a variety of commitments to non-interference with foreign firms' property rights, they have developed a repertoire of ways to (sometimes) appropriate benefits from FDI. The set of relevant government actions ranges from the full transfer of ownership from a foreign firm to the state, to breach that unlawfully reduces foreign firms' ability to benefit from their investments even when ownership status is left unchanged.[36] Often, how governments break contracts follows from the why.

Nationalization, or "the forced divestment of the equity ownership of a foreign direct investor,"[37] is the most widely recognized form of government breach of contract. Nationalization is the full or near-full expropriation of foreign assets that moves ownership and control from a foreign private entity to the host government. Lipson argues that the term "nationalization," which emerged after World War I, reveals a kind of expropriation that is "rooted in broad conceptions of the social character of property rights."[38] Nationalization can come about when armed soldiers storm a foreign installation and wrest control in the name of domestic interests. More broadly, however, we can think of nationalization as a phenomenon wherein foreign firms are coerced into selling their property to the government at a small (or non-existent) fraction of the property's market price.[39] Incremental or partial nationalization is another type of breach, in which host governments strike a sort of balance, allowing host governments to achieve some benefits of national ownership while retaining some access to the expertise offered by foreign firms. Often these nationalizations go just far enough to give the host government a majority stake in the investment. In this book's parlance, forced change in ownership makes nationalization a breach of contract whether or not compensation is paid. Predictably, it is rare (or non-existent) that foreign firms and host governments are equally pleased with the amount of compensation when it is provided.[40]

From 1990 to 2009, some 41 emerging economies have nationalized approximately 150 foreign-owned firms.[41] The Democratic Republic of Congo nationalized railways and gold mines; Egypt nationalized some hotels; Kazakhstan nationalized investments in aluminum, iron, coal, oil, and telecommunications; Lesotho nationalized diamond mines; Venezuela nationalized assets as diverse as corn processing, ketchup manufacturing, and cement manufacturing. Nationalization of foreign-owned farmland has been an issue in Paraguay, Zimbabwe, Brazil, Namibia, South Africa, and elsewhere. At least a handful of states have nationalized property each year. Thus, governments around the

[36] Kobrin 1980, 1984.
[37] Kobrin 1980: 65.
[38] Lipson 1985: 120.
[39] Tomz and Wright 2010.
[40] Of course, nationalizations adjudicated behind closed doors may be agreeable to both parties.
[41] Hajzler 2012.

developing world sometimes break contracts with foreign investors even to the extent of transferring ownership to the state.

Nationalization is not the only way governments can violate foreign firms' contract sanctity, however. One window into the variety of ways governments break contracts with foreign firms is the political risk insurance (PRI) industry, which has grown to provide foreign firms one means of managing the risk of breach of contract.[42] From 2008 to 2012, at least US$168 million was paid in PRI expropriation claims.[43] Lloyd's of London, the insurance market responsible for much privately provided PRI, offers coverage for confiscation risks, expropriation of tangible assets, (written) contract frustration, and more.[44] The World Bank Group chartered a PRI affiliate, the Multilateral Investment Guarantee Agency (MIGA), in 1988. Like other providers, MIGA sells coverage against government actions "that may reduce or eliminate ownership of, control over, or rights to the insured investment."[45] Subsidized PRI comes from national organizations, such as the US Overseas Private Investment Corporation (OPIC) founded in 1971. OPIC's Expropriation/Improper Government Interference policies cover "abrogation, repudiation, and/or impairment of contract, including forced renegotiation; imposing of confiscatory taxes; confiscation of funds and/or tangible assets; and outright nationalization." OPIC also specifies coverage for "creeping expropriation that results from a series of actions that, in sum, deny your rights to a project."[46] Kobrin defines "creeping expropriation" as the "deprivation of the benefits of ownership" rather than change in ownership per se.[47] Put differently, the host government acquires value from or takes value away from a foreign-owned investment rather than acquiring an equity stake. Governments can force renegotiations of written contracts; block repatriation of capital; discriminate against a foreign firm in favor of another (domestic or foreign) market player; target changes in tax and regulatory regimes toward particular foreign assets; revoke licenses; stop payment to foreign firms performing services for the host government; and more.[48] The cases discussed through this book demonstrate the wide variety of creative ways governments have carried out contract breach with foreign firms.

[42] As is true of insurance in general, payouts from political risk insurance rarely make a foreign firm whole. In particular, the investor is often only compensated for the value of the assets without taking into account future cash flow.

[43] Data from the Berne Union. Countries with the most publicly known PRI exposure at the end of 2012 included Russia, China, Kazakhstan, Turkey, India, and Brazil. This is excluding private claims, especially those made through Lloyd's of London, a major PRI provider.

[44] Bolt, Tom, "Market Bulletin: Lloyd's Risk Code Scheme," Ref. Y4399, *Lloyd's*, 25 May 2010.

[45] MIGA website. http://www.miga.org/investmentguarantees/. Baker 1999.

[46] OPIC website. http://www.opic.gov/insurance/coverage-types/expropriation.

[47] Kobrin 1980: 68.

[48] Kobrin 1982, Lipson 1985, Jakobsen 2006. Kobrin identifies four kinds of adverse state action: expropriation without due process in local law, "extra-legal forced transfer of ownership," forced sales, and forced contract renegotiation. Kobrin 1980: 68.

My use of the terms "government breach of contract" and "contract risk" excludes instances of political violence, civil unrest, terrorism, and war. These excluded categories pose real risks for foreign firms investing in emerging economies and can result in broken contracts. However, this book focuses on the conditions under which governments break contracts in a way that is not a by-product of a larger violent crisis.[49] Rather, breach occurs when government actions have the effect of discriminating against foreign firms' property in favor of domestic property, or against one foreign firm in favor of another; when direct commitments to particular foreign firms are broken; or when the government takes action that devalues a foreign firm's property without regard to the general principle of non-interference with private property that is part of the concept of rule of law. In these situations, government policy changes are not merely "unfriendly" to foreign firms but rather violate particular commitments the state has made to allow foreign firms to operate. Such instances, when sovereignty trumps foreign firms' property rights, constitute a real puzzle, given the expectation that economic globalization pushes governments to prioritize this most basic of foreign firms' interests.

BILATERAL INVESTMENT TREATIES (BITS) AND BREACH

For years there were no formal, international legal protections of foreign investors' property rights in host countries, despite concerted efforts by traditional capital-sending and capital-receiving countries to develop a multilateral investment protection regime (Chapter 7). But a substitute form of international legal protection, Bilateral Investment Treaties (BITs), has spread across dyads to create a web of treaty protections for foreign firms' rights abroad. Germany and Pakistan signed the first BIT in 1959, but only 386 treaties were signed by 1989, mostly initiated by Western European countries. The United States started pursuing BITs only in the 1980s, at which time it gave up its long-time focus on Friendship, Commerce, and Navigation Treaties. US buy-in helped to legitimate BITs as "the policy tool of choice" for all countries.[50] With emerging economies looking to private foreign firms for external capital after the 1980s debt crisis, conditions were right for BITs to take off. BITs became the popular device through which host governments could commit to foreign firms in order to encourage FDI, and the credibility of BITs was enhanced by the deterrence of FDI that was expected to result from BIT violations. Moreover, as a state's neighbors signed BITs, the state faced greater incentives to likewise incur "sovereignty costs" in order to remain a competitive destination for foreign

[49] Actions covered by the theory include instances in which the original breach may have been inadvertent, but the government later commits to that adverse action – as signified by, for example, allowing an international legal action to go forward.

[50] Jandhyala et al. 2011.

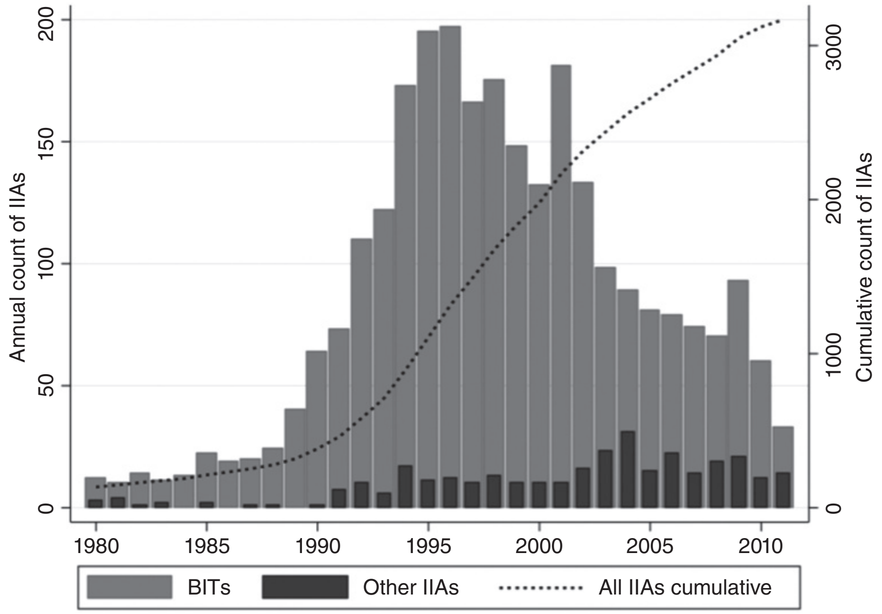

FIGURE 2.1 **International Investment Agreements (IIAs)** (1980–2011) Through the end of 2011, UNCTAD counted 318 non-BIT instruments that included investment protections, as compared to 2731 BITs.
Source: UNCTAD.

investment.[51] Additionally, in the late 2000s, South-South BITs, or BITs signed between capital importers, were a growing phenomenon. By 2011, over 3,000 BITs, as well as Preferential Trade Agreements (PTAs) that include investment protection chapters, had been signed (see Figure 2.1).[52]

BITs are inter-state treaties while, at the same time, they act as "meta-contracts" confirming host governments' commitments to non-interference with foreign firms' property rights. BITs vary in important ways but, in general, they codify many of the implicit commitments host governments make to foreign firms' contract sanctity (Chapter 3). BITs generally provide foreign investors the guarantee of national treatment as well as most favored nation (MFN) treatment, so that foreign investors from all home countries with BITs and MFN clauses receive treatment identical to the best treatment offered to any nationality of investors. Non-discrimination is generally required

[51] Elkins et al. 2006. For example, in Chile, prominent politicians used rhetoric about FDI competition to "sell" the ICSID convention and the country's first BITs in the early 1990s. Montt 2007: 21.
[52] Included in this network as of 2009 are 77 PTAs that explicitly cover investment. 56 have a services chapter, 49 have an investment chapter, and 7 replace a BIT with a new investment chapter. Hicks and Johnson 2012, Salacuse 2010.

"post-establishment," or after foreign investments have been made in the host economy.[53] BITs limit restrictions on exchange controls, ensuring that foreign firms can repatriate capital. Requirements for prompt, adequate, and effective compensation for expropriated investments are also standard. The vast majority of BITs contain few if any legal obligations of foreign investors toward host governments.

The most vital and unique component of BITs is the procedural right to sue host governments directly in international investment arbitrations (IAs).[54] In this way, BITs get around "espousal," avoiding the mechanism "whereby an injured national's country assumes the national's claim as its own and presents the claim against the country that has injured the national."[55] While firms with trade grievances must get their home governments to bring their claims before the WTO, BITs allow firms themselves to take action against sovereign governments. In fact, home governments may not know when or how their investors are using a BIT.[56]

Moreover, firms can often file IAs without first exhausting local courts.[57] Alongside avoiding "espousal," legal observers see this as one of the strongest protections that many (though not all) BITs afford. From the capital-sending government's point of view, allowing firms to avoid domestic courts gives those firms the opportunity to avoid potential bias and/or corruption in host-country legal systems. Indeed, legal observers were surprised when, in one of the biggest host government–foreign firm conflicts of the early 2000s, Chevron agreed to go to Ecuadorian courts instead of exercising its right to go to international arbitration. In 2011, an Ecuadorian court found Chevron liable for US$8.6 billion in environmental damages, which a later Ecuadorian court increased to $18 billion when Chevron did not make a public apology. The US Supreme Court refused to hear an appeal blocking the judgment.[58] Whether Chevron would have fared better in IA is, of course, impossible to say. Even if Chevron had been found liable in IA, there is no formal appeals process and cases cannot be annulled as a result of reinterpretation of facts.[59] However, the inclusion of

[53] This allows host governments to discriminate against foreign firms "pre-establishment," or prior to their entry. All states apply pre-establishment measures, such as restrictions on the industries in which foreigners can acquire assets. Vandevelde 1998. The United States and Japan are known to press for "pre-establishment" protections in BITs as well as the traditional post-establishment protections.

[54] Throughout the book, I focus on public international investment arbitration, which is part of a larger category of investor-state dispute settlement (ISDS) techniques, including alternative dispute resolution (ADR) through private mediation.

[55] Sauvant and Sachs 2009: 5.

[56] State-to-state arbitration on behalf of foreign investment is also possible under some investment treaties but has been rarely used.

[57] Franck 2007, Yackee and Webb 2008, Blake 2013.

[58] "Chevron Corp on Tuesday lost a US Supreme Court bid to block an $18.2 billion judgment against it in Ecuador in a case over pollution in the Amazon jungle," *Reuters*, 9 October 2012.

[59] The United States has made reference to an appeals process, should one emerge, in BITs in the early 2010s. Sauvant 2008.

direct-to-international-arbitration clauses in many BITs implies that many home countries believe that their firms are likely to fare better outside of host-country legal systems.[60]

BITs and public IAs have had the effect of codifying and publicizing a variety of government breaches of contract like never before. As Simmons puts it, BITs have brought to light the phenomenon that "if you build (sign) it, they will come (litigate)."[61] Public IAs are the manifestation of that ugly reality of litigation. As BITs have spread, so too have more foreign firms filed IAs against host governments. Most BITs allow firms the ability to keep IAs private, so the observable public trends should be taken as only a slice of the population of IAs. Still, the number of public IAs has increased rapidly throughout the 2000s (see Figure 2.2). The most public venue for IAs is the

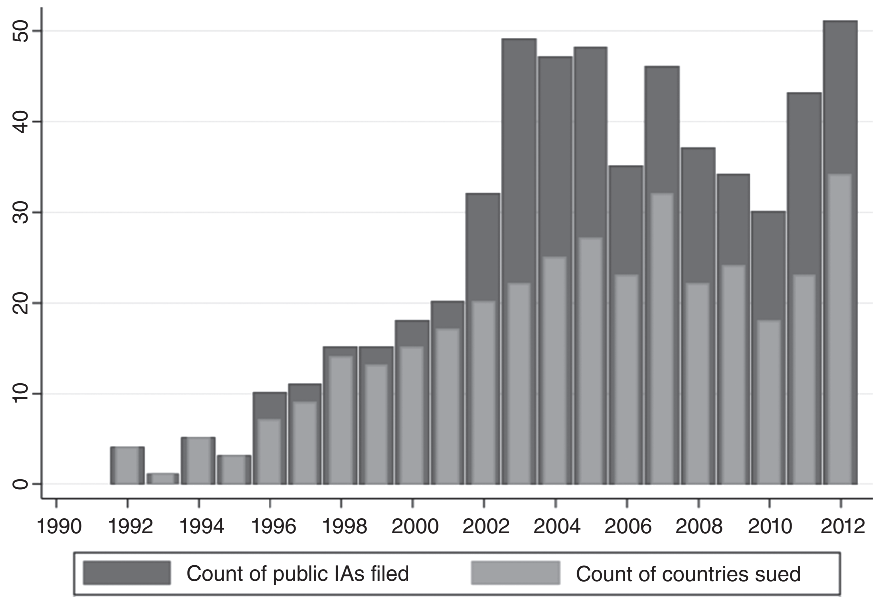

FIGURE 2.2 **Count of Public International Investment Arbitrations (IAs) and Countries Sued** (1990–2012) In this period, at least 110 countries have been sued in at least 541 public IAs.
Sources: Data on publicly disclosed IAs is assembled from author's records, in addition to the United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases. International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed March 2013.

[60] See Chapter 5 for a discussion of interactions between domestic and international legal systems in the context of contract breach in Ukraine.
[61] Simmons 2014: 30.

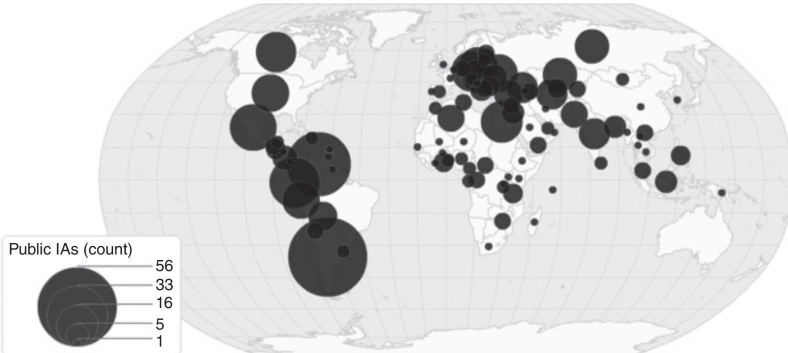

FIGURE 2.3 **Distribution of Public International Investment Arbitrations (IAs) Worldwide (1990–2012)**
Sources: See Figure 2.2. Map from chartsbin.com.

International Center for the Settlement of Investment Disputes, a World Bank entity that provides rules for arbitration as well as public three-person tribunals.[62] Other public IAs tend to be brought under a set of rules developed by the United Nations Commission on International Trade Law (UNCITRAL) and heard at a variety of venues, including the International Chamber of Commerce, the Permanent Court of Arbitration, the London Court of International Arbitration, the Stockholm Chamber of Commerce, and others. Parties also engage in ad hoc arbitration under UNCITRAL rules, the terms of domestic investment protection laws, or contract-specific clauses. IAs brought on an ad hoc basis or in these kinds of venues tend to allow parties to keep their IAs private. Nevertheless, some IAs that have taken place in these kinds of circumstances have been made public.

Figure 2.3 indicates the spread of public IAs around the world. Some 110 countries have been public respondents in IAs from 1990 to 2012. Of 541 public IAs in this period, forty-two (8 percent) have been brought against or occurred between developed countries – mostly between the United States and Canada under the terms of NAFTA Chapter 11. Many suits have been brought against Latin American states, with Argentina having faced fifty-six public IAs, many of which can be traced to its 2002 default and concomitant government non-payment of many of its direct obligations to foreign investors. Venezuela has faced a significant number of suits, resulting in its case from a greater number of underlying events. The countries of Central and Eastern Europe, too, have faced a high number of public IAs. This is puzzling, as the 1990s and 2000s have been the key transition years in which these post-communist countries set about making their international reputations as credible market economies. East Asian

62 The existence of and parties to an ICSID IA are made public although the content of the case can be kept somewhat private.

TABLE 2.1 *Public International Investment Arbitrations (IAs) by Industry (1990–2012)*

Industry	Count	Pct
Energy	98	18%
Utilities	78	14%
Manufacturing	74	14%
Services	69	13%
Construction	49	9%
Mining	45	8%
Finance	42	8%
Communications	34	6%
Agriculture	22	4%
Trade	15	3%
Unknown	15	3%
Total	541	

Source: See Figure 2.2.

countries have in the early 2010s begun to face a handful of public IAs, although levels are still lower than in other parts of the world.

Public IAs typically deal with aspects of "creeping" expropriation: forced contract renegotiations, regulatory infringements, discriminatory policy changes, and other undue interference with foreign firms' operations. Some have to do with government breach of contract with what were once state-owned, now privatized, assets. BITs and the public IAs they engender have thus helped to make public more instances of broken contracts in ways beyond the transfer of ownership to the state.

Table 2.1 classifies public IAs by the sector of the claimant, demonstrating that they have a wide variety of origins. As might be gleaned from the popular press, a large portion of the 541 public IAs brought worldwide from 1990 to 2011 have been brought by firms in the energy sector, particularly in oil and gas. A significant proportion has also occurred in utilities, with many dealing with electricity transmission grids or water and sewage concessions. There have also been numerous public IAs in services and manufacturing, despite the fact that these industries are often thought of as the most difficult to expropriate, because investments are relatively easy to move.[63] Service sector IAs have concerned industries like tourism, gambling, and the management of airports and ports, while manufacturing IAs have dealt with everything from pharmaceuticals to textiles, tobacco processing, and cement production. Other cases are spread across a variety of sectors: construction, mining, finance, communications, agriculture, and trade. Thus, while there is certainly an idiosyncratic

[63] E.g. Vernon 1971.

selection process behind whether a particular firm's broken contract makes it all the way to a public IA, firms across a variety of sectors have nevertheless taken advantage of the institution of investment arbitration.

In the case of a public IA, several conditions hold: foreign investors have access to a BIT or another mechanism through which the host government has committed to international investment arbitration; foreign investors commit resources to a costly and imperfect means of getting restitution; host governments commit to their actions enough to refuse to settle and to allow an accusation of contract breach to go public; and parties are willing to make the dispute visible to other current and potential foreign investors. Indeed, a dispute must wind its way through many steps before becoming a public IA: the government threatens breach, breach occurs, the foreign firm threatens to sue, and a suit occurs. As a result of this selection process, not every instance of breach or nationalization results in a public IA. Moreover, many disputes make it into national newspapers but not the international legal system. Still more broken contracts may be common knowledge to interested investors but may not make it into business media.[64] Still others are kept private by firms. Therefore, public IAs should be thought of as the tip of the iceberg of government breach of contract, while the size and shape of the iceberg is unknown. Nevertheless, the rise of BITs and public IAs allows us to see the spread and depth of the phenomenon of government breach of contract with foreign investors as never before.

A BIT OF DETERRENCE?

If BITs now encode foreign firms' contracts, and carry penalties for breaking them, why have they not conclusively stopped the incidence of government breach of contract? The coexistence of breach and BITs highlights the limits of international law as a source of explanation for variation in government breach of contract with foreign firms. Abbott and Snidal argue that the presence or absence of normative covenants created by "soft law" can be decisive in explaining whether or not, say, a treaty commitment is upheld.[65] Indeed, like any entity that makes contracts, a host government only cares to maintain a credible commitment to foreign firm contracts if it benefits from making that commitment. As such, a BIT is "founded on a grand bargain: a *promise* of protection of capital in return for the *prospect* of more capital in the future."[66] To the extent that the second half of this bargain (and the normative covenant that stands behind it) does not hold, there is less reason to expect BITs to conclusively stop host governments from breaching contracts with foreign firms.[67] In fact, the

64 Such disputes are the focus of Chapters 5 and 6 on Ukraine, Moldova, and Romania.
65 Abbott and Snidal 2003.
66 Salacuse and Sullivan 2005: 5 [emphasis in original].
67 This also presumes that the knock-on costs BIT violations might have in other issue areas are sufficiently low.

evidence on whether BITs successfully attract increased foreign investment is mixed at best: some find little or no evidence of increased FDI,[68] while others find only conditional evidence that BITs increase FDI.[69] Indeed, if governments are signing BITs in large part because everyone else is, there may be little reason to expect them to be effective.

The relative invisibility of BIT benefits to scholars, let alone policymakers, has led several host governments to question their commitments.[70] The United States had an "awakening of sorts" that being sued might be more trouble than it is worth; in 2001 the United States, Canada, and Mexico agreed on limits to arbitrator discretion under NAFTA's Chapter 11, which had been equivalent to standard BIT protections.[71] Indonesia, Pakistan, South Africa, Bolivia, Ecuador, Nicaragua, India, and Venezuela have been publicly skeptical of BITs; since 2008, Bolivia, Ecuador, Venezuela, and Indonesia have withdrawn from some (though not all) investment treaties.[72] As of 2014, Brazil has not ratified any BITs, though it has engaged in some BIT negotiations. And in the early 2010s it emerged that Argentina had not paid any of its outstanding IA awards, and the government went on to effectively declare that it would not pay. Argentina has struggled to remain "judgment-proof," which means keeping assets at home rather than overseas where award winners can claim them in lieu of other compensation.[73] By 2013, however, some investors began accepting Argentinian government bonds as substitutes for their full outstanding awards (a risky move given that the government's solvency was again in question).

Thus, while BITs remain the de facto basis of the international investment protection regime, there is pushback by signatories, not to mention advocacy groups, against the constraints that BITs place on host government behavior. What is more, even when BITs are in place, host governments undertake actions that violate them – "off-equilibrium" behavior that the existence of a BIT is thought to deter. The presence and persistence of government breach of contract – as embodied, for example, by public IAs – suggests that there is more permissive space for even capital-seeking governments to act contrary to foreign firms' interests than we might have otherwise thought.

68 Hallward-Dreimeier 2003, Tobin and Rose-Ackerman 2004, Yackee and Webb 2008, Poulsen and Aisbett 2013, Aisbett 2009.

69 Salacuse and Sullivan 2005, Neumayer and Spess 2005, Kerner 2009.

70 Young and Tavares 2004.

71 Free Trade Commission (NAFTA), Notes of Interpretation of Certain Chapter 11 Provisions, 30 July 2001.

72 Van Harten 2010: 2–5.

73 Enforcement lawyers chart the asset flows of these countries and look for opportunities to make claims. The docking of an Argentinian naval vessel in Ghana in 2012 provided one such opportunity to take over Argentinian assets, although ultimately ownership of the vessel remained with the Argentinian government. Argentina successfully argued before the International Tribunal for the Law of the Sea that warships have immunity from civil claims when they dock at foreign ports.

WHEN GOVERNMENTS BREAK CONTRACTS

Governments around the world are tempted to and sometimes follow through with government breach of contract. This is despite the fact that FDI, in aggregate, is thought to confer development benefits through the transfer of technology and management know-how, not to mention long-term capital, employment, and tax revenues for host countries. But short-term gains can be as tempting for governments as they are for any party to a contract. Governments can use breach of contract to raise revenues at foreign firms' expense, act on sector- and asset-specific motivations, carry out foreign policy, and satisfy domestic interests, whether via corruption or otherwise. Governments may simply want to get out of bad deals. The spread of BITs and the rise of public IA have made it easier for us to see evidence of the many ways in which governments act out these motivations, not only through nationalization but also through a variety of policies that have the effect of unlawfully devaluing foreign property. Given that so many motivations to breach exist, that governments breach in so many ways, and that breach continues despite the institutionalization of international law that makes breach events visible and codified like never before, the question arises: what are the conditions under which governments have the permissive space to break contracts with foreign firms?

3

National Diversity and Contract Sanctity

Many observers believe that economic globalization has a destructive impact on the nation-state. In this view, the effects of the integration of global markets are especially constraining for capital-poor countries that need foreign investment for employment and development. Governments in these countries face pressure to align their policies and institutions with foreign firms' interests in order to gain investors' trust and remain competitive destinations for mobile capital. Some scholars see the conflict between host-government autonomy and foreign firms as a stark and intractable problem that creates a major tension between democracy and economic integration.[1] Others have identified issue areas where domestic policymakers still exercise some autonomy, such as labor and environmental regulation.[2] These domains are often seen, however, as exceptions in a world in which the overall pressures of the market work to advance investor interests. Whatever variation there may be in investor interests over policy, the idea that investors' interests converge on the protection of private property rights is virtually unquestioned.

From a foreign firm's point of view, rule of law in a destination country reduces to the host government's commitment to allow the foreign firm to operate once invested. Without the protection of its property, a foreign firm has little reason to believe investment is in its best interests. In investment transactions, the protection of private property can show up in a number of guises. Host governments are the counterparty on privatizations; they license foreign firms to run infrastructure and natural resource concessions; they commit to regulatory standards in the terms of investment agreements; and they have signed some 3,000 BITs and other instruments that protect foreign firms under the force of international law. In hopes of enabling productive foreign

[1] Rodrik 2011, 1997; Berger 2000; Kobrin 2001; Strange 1996.
[2] E.g., Mosley 2011, Murphy 2004, Vogel 1997.

investment, host governments commit to upholding property rights protections by entering formal and informal contracts with foreign firms. Without a commitment to contract sanctity by the host government, the expectation has been that foreign firms will divert their investments and flee.

But the fact is that, at some time or other, the overwhelming majority of emerging-economy governments has violated contracts made with foreign firms. Host governments sometimes forcibly transfer ownership of foreign property through nationalization and expropriation, and they also devalue foreign holdings through forced contract negotiations, discriminatory policy changes, and other undue interference with foreign firms' operations. Nevertheless, emerging-economy governments, keen to access foreign capital, do not always break contracts, even when disputes arise. Even as FDI has flowed into emerging economies worldwide, when, why, and how such host governments respect the prior contracts they have entered into with foreign firms varies across countries and over time.

The crux of my explanation for variation in foreign firms' contract sanctity is that the prospect of capital flight does not universally shield foreign firms from adverse government action. Not all foreign firms respond in ways costly to the host government when the host government breaks contracts with them. Instead, capital flight following breach is most likely to occur along national lines, and public protest over breach is limited to co-national actors of the targeted firms. Contrary to the conventional wisdom, nationality and nation-states are embedded in economic globalization at both the home and host ends of the investment transaction. National governments sometimes renege on commitments to foreign firms, and foreign firms' national origins shape the risk that host governments will renege.

Nationality affects firms' contract sanctity via numerous pathways. Nationality is structurally important to a foreign firm's property rights, as it is a cornerstone of the modern, bilateral institutions that codify foreign investor rights. Bilateral politics, whether acrimonious or friendly, spill over into investor decision-making. Home-country business traditions shape the kinds of contracts firms enter into with host governments. These factors make firms of the same nationality, or "co-national firms," more likely to share a collective sense of risks to their contract sanctity. When the host government breaks a contract, firms of the same nationality are the most likely to respond with actions that are costly to the host government. These costly actions include FDI exit and diversion as well as protest exercised together with home-country diplomats. In contrast, non-co-national actors are less likely to share a collective sense of contract sanctity. When firms do not share this collective good, they are unlikely to draw down or divert investments or engage in protest around breach. Shared nationality is a powerful shield against breach, but nationality shields stop at national borders. Thus, the expectation that aggregate investor behavior will enforce foreign firms' contracts is flawed, because investor willingness and ability to act punitively toward a host government depends on nationality.

When we consider "nationality shields" against breach at the level of the economy as a whole, we see that firm nationality has a surprising effect on contract sanctity. Greater national diversity among a host country's foreign firms makes it easier for a host government to breach contracts. With more diverse FDI present in the host economy, governments can more easily recoup the loss of capital brought about by breach of contract with any one national group, because governments can turn to other groups for current and future capital access. Higher FDI national diversity leaves more opportunities for host governments to exploit other nationalities' indifference when penetrating one nationality's shield.[3] Thus, the set of foreign firms present in a host economy shapes the risks any given firm faces and the opportunities host governments have to capitalize on low costs to breach.

Ultimately, if we take hosting a more diverse set of foreign firm nationalities as an indicator of the degree of integration of the host country into the global economy, an important implication emerges: economic integration need not move together with increased respect for foreign firms' property rights. Instead, economic integration with more nationally diverse firms reinforces the host government's national autonomy, including the autonomy to act contrary to rule of law.

In this chapter, I first describe research focusing on state-level characteristics as explanations for breach. Finding these wanting, I move to the level of the firm to explore why and how national origin matters to foreign firms' contract sanctity abroad and to firms' access to resources with which to protest breach. Next, I explain how foreign firms' willingness and ability to deter breach depends on the diversity of investor nationalities present in an economy. I then address another form of firm-level heterogeneity – by industry – and describe how industry effects may exist alongside an independent role for national ties. I conclude by previewing the quantitative and qualitative research strategies used to test the nationality shield theory, as employed in the second part of the book. Common national identity can be a source of power for foreign firms in their relations with host governments, but increasing FDI national diversity generates opportunities for host governments to reconsider their commitments to foreign firms' property rights.

STATE-LEVEL EXPLANATIONS

The quickest off-the-shelf explanation for the incidence of government breach of contract predicts that governments in countries with weaker rule of law, with weak domestic institutions and arbitrary government behavior toward domestic actors, should breach more with foreign actors. However, breach of contract is

[3] Certainly, executives at non-co-national firms can be sympathetic to the plight of other foreign firms. But from the host government's point of view, the absence of protest by non-co-national firms is observationally equivalent to indifference. Chapter 8.

spread across the world. Some 110 countries at both high and low levels on rule-of-law indicators have been respondents in litigation brought by foreign firms over property rights violations. Rule-of-law measures are insufficient to explain variation, at least when not conditioned on other factors.

Much work in political science looks at whether some governments are by nature more opportunistic than others and thus more likely to violate foreign firms' property rights. In particular, scholars debate the ability of different regime types to make more or less credible commitments to refrain from breach of contract. O'Neal first argued that foreign direct investors are drawn to authoritarian regimes, because, whatever the risks those governments might present, rates of return are higher there than in countries with democratic regimes.[4] Jensen has done much to discredit this notion, finding ample evidence that FDI moves together with democracy.[5] For example, Jensen finds that US multinationals have smaller operations in countries that are more autocratic.[6] The debate has since turned to what exactly it is about democracy that might be attractive or not to foreign investors. Li and Resnick contend that it is not democracy as a whole but democracies' ability to more credibly commit to contract sanctity that attracts FDI. In their analysis, elements of rule of law attract FDI, but the policy uncertainty associated with democratic institutions actually deters FDI.[7] Jensen and Young find that multinational corporations investing in democratic regimes enjoy lower premiums on expropriation insurance, but, consistent with Li and Resnick, this is particularly true in countries with highly constrained executives in which policy uncertainty is less of an issue.[8] Humphreys and Bates also find that more political competition and more checks on the executive predict policies that are less extractive in African countries.[9] And in an analysis of nationalization events from 1960 to 1990, Li shows that democracies with lower executive turnover were less likely to expropriate than other democracies, while democracies as a whole are less likely to expropriate than autocracies.[10] Taken together, this literature suggests that democracies with higher policy stability are significantly more likely to maintain contract sanctity with foreign firms and thus attract FDI in part because of those credible commitments.

The parties responding to those credible commitments, however, remain unspecified. When it comes to explaining variation in contract sanctity, state-level explanations fall short because they have little to say about the relationship

[4] O'Neal 1994.
[5] Jensen 2003, 2006.
[6] Jensen 2008.
[7] Li and Resnick 2003.
[8] Jensen and Young 2008.
[9] Humphreys and Bates 2005.
[10] Li 2009. Li complicates the story somewhat: he finds some evidence that longer leader tenure in autocracies decreases the incidence of nationalization, providing new support for the idea that policy stability can attract investment even if it comes within an autocratic regime.

between threatened firms, the host government, and other firms. What are the implications of a given broken contract for other foreign firms? On one hand, Jensen and Johnston imply that a broken contract increases risks that all foreign firms will be subject to opportunism by the host government, for breach has generated more resources for the government that could now offset costs of future breaches.[11] On the other hand, we might posit that a given foreign firm's broken contract only signals increased risks to subsets of other investors. To discern whether the signal sent by a breach of contract is indeed universal, we need a fuller theory of foreign firms' understanding of their contract sanctity. I contend that nationality is a key axis of variation in the value of signals sent by breach. Foreign firms' national origins generate variation in their ability and willingness to act in ways costly to the host government following a breach of contract with a firm of a given nationality.

NATIONAL ORIGIN AND CONTRACT SANCTITY

Foreign firms observing a host government's breach of contract with another firm face this question: are we next, or can we safely ignore that firm's broken contract? Firms do not form a single identical estimate of risks to contract sanctity in a host country, and they need not interpret or draw the same conclusion from information provided by another's broken contract. Only those firms that see the host government's actions as threatening to their own contracts are likely to react negatively. More indifferent firms, on the other hand, are unlikely to change their investment plans or their behavior toward the host government in response to a given breach of contract.

I explain variation in the constraints firms place on host governments by focusing on which firms are most likely to react negatively to a given broken contract. To do this, I turn to an under-explored firm characteristic: nationality. Nationality differentiates the contract risks faced by foreign firms, which makes firms more likely to respond negatively to government breach of contract with a co-national than they would otherwise. In what follows, I describe how the shield of nationality is constituted: various aspects of nationality come together to make nationality a focal point, and nationality provides a variety of resources that form a defense against breach. Nationality acts through legal, diplomatic, business, and domestic political mechanisms to generate a collective sense of contract sanctity among co-nationals and to give co-nationals the ability to defend that collective good.

The modern structure of foreign firm property rights embeds investor national origins in contract sanctity. BITs and related instruments encode and protect foreign firm property rights, replacing failed efforts at a multilateral investment protection regime (Chapter 7). Since the 1990s, BITs have come close to saturating advanced–emerging economy dyads and are

[11] Jensen and Johnston 2011.

spreading to emerging–emerging economy dyads. BITs enable public international investment arbitrations (IAs), or international lawsuits that make the offending government and the offense public. One has to know who has been expropriated in order to punish the government for expropriation; BITs and IAs help with this advertisement. But the consequence of the network of bilateral commitments is that national origin determines the international legal rights to which a firm has access.[12] BITs and "public IAs" advertise investment protections and breach of contract by nationality.

The protections afforded to particular national groups of investors under BITs vary with both home- and host-country characteristics at the time of BIT negotiations. For example, thanks to differences in home- and host-government bargaining power, BITs vary on whether disputes must be settled at the World Bank's International Center for the Settlement of Investment Disputes (ICSID), the most public setting for IAs.[13] French BITs tend to give priority to ICSID, while German BITs allow cases to be heard at all international arbitration tribunals; British BITs fall somewhere in between.[14] BITs also vary in the extent of host-government obligations to foreign investors and the circumstances under which host governments agree to IAs.[15] Legal scholars characterize Norwegian BITs as being more sensitive to host-country environmental policies, giving host governments more latitude to prioritize the environment over Norwegian investor interests. France, for its part, insists on an exception for cultural activities in its BITs that necessarily works in both directions. Dutch BITs offer foreign investors very high levels of protection, so much so that accessing these BITs may be one factor behind some firms' incorporation in the Netherlands to acquire Dutch nationality.[16] Additionally, "fair and equitable treatment" (FET) standards have become one of the most important parts of BITs in litigation, but the breadth of interpretations of FETs differs by BIT.[17] As a result of such specificities in each home country's set of bilateral treaties, claims made under the particular BIT to which a firm has access sends more relevant signals of contract sanctity

[12] Limited multilateral and regional treaties with chapters on investment protection exist, but as of 2011, only the Energy Charter Treaty, the North American Free Trade Agreement (NAFTA), and several Latin American regional trade and investment agreements have been cited in public IAs. The vast majority of public IAs have been facilitated by BITs.

[13] Allee and Peinhardt 2011.

[14] Dolzer, Rudolf, "BITs Around the World: Different Substantive and Procedural Approaches" (presentation, *50 Years of Bilateral Investment Treaties Conference*, December 2009, Frankfurt, Germany). Dolzer and Stevens 1995.

[15] Blake 2013.

[16] Dolzer, Rudolf, "BITs Around the World: Different Substantive and Procedural Approaches" (presentation, *50 Years of Bilateral Investment Treaties Conference*, December 2009, Frankfurt, Germany).

[17] Interview, US official, Washington, D.C., 2013. Tudor (2008) counts seven categories of drafting formulations of FETs in an analysis of 365 BITs.

than claims made under other BITs.[18] Further, should firms of different nationalities face a common threat of breach – say, by industry – legal action over that breach is likely to be divided along national lines. Finally, for firms without access to a BIT, and thus without guaranteed international legal recourse, the operations of BITs are even more remote to contract sanctity. Structurally, investor national origins do much to determine investors' property rights protections under international law.

Domestic law in home countries can also set apart the risks a particular national group of investors faces in a host country. The US Foreign Corrupt Practices Act of 1977 (FCPA) provides credibility to the claim that American firms cannot pay bribes, something executives (American and otherwise) with experience in many countries readily acknowledge makes a difference on the ground. For decades, the FCPA had no equivalent in other advanced industrial countries. Finally, advanced industrial countries' laws on foreign corrupt practices converged with the 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business. However, variation continues in OECD home countries' commitments to enforcing their anti-bribery laws, which allows different nationalities different latitude in forming deals with host governments.[19] The United Kingdom Bribery Act of 2010 goes farther than the OECD Convention or the American FCPA: it prevents British firms from paying government officials to expedite bureaucratic processes. Due to enforcement and legislative differences, then, American and British firms continue to face particular constraints when contracting with host governments. Variation in constraints on bribery generates variation in the kinds of contracts being entered into by different nationalities. Correspondingly, firms of different nationalities have different expectations about the legitimacy and thus expected sanctity of each other's contracts.

Foreign-firm nationality has long carried with it the burden or blessing of bilateral politics. Firm decision-making is influenced by bilateral political factors – and one firm's investment decisions are unlikely to be influenced by a different nationality's bilateral politics. Bilateral trade treaties tie some home and host countries closer together economically than others. Military and diplomatic relations, cultural ties, and the role of a particular home country in the host country's domestic politics generate uneven levels of attention to a national group of investors, on the part of both home- and host-country officials.[20] Variation in government attention to or the prominence of particular

[18] This evidence of variation by home country goes against some scholars' arguments that BITs are effectively interchangeable (Elkins et al. 2006, Kerner 2009) or that signals diffuse widely (Büthe and Milner 2009). The presence of "most favored nation" (MFN) clauses in BITs does make them more interchangeable. However, MFN interpretations have varied considerably across public IAs.

[19] Kaczmarek and Newman (2011) find that US actors continue to take the lead in anti-bribery enforcement.

[20] Hirst and Thompson 1995. For example, Romanian diplomats are said to have good access to officials in Beijing – particularly when it comes to commercial relations – thanks to historical and

national groups translates into varying contract risks. For example, bilateral FDI flowing from advanced to emerging economies decreases in the presence of a bilateral military conflict, as well as in the presence of bilateral economic sanctions.[21] On the other hand, bilateral FDI increases in the presence of a military alliance.[22] Emerging economies with a US troop presence receive more US-origin FDI but not more aggregate FDI.[23] While these examples concern matters of war and peace, further evidence suggests that firms take even incremental changes in bilateral relations into account when making investment decisions. For example, Desbordes finds that American firms increase their required return on investment when diplomatic tensions heighten with developing countries.[24]

When home governments themselves act as foreign investors via state-owned firms, the link between national origin and contract sanctity is even clearer. State-owned firms have incentives to sacrifice profit-maximization in exchange for meeting foreign policy goals, which can make them more likely than private foreign firms to invest in the riskiest emerging economies.[25] When a home government has higher levels of ownership or involvement in the affairs of its nationality's firms investing abroad, host governments are primed to tie the treatment of those firms to bilateral political relations. Home governments' investments in the form of Sovereign Wealth Funds (SWFs) could act as an economic stick wielded to protect contract sanctity: home governments could credibly commit to divert SWF investments in response to contract breach. In sum, so long as a host country's political and diplomatic relationships vary across home countries, bilateral politics can generate variation in foreign firm contract sanctity by national origin.

High politics continues to be a factor in host governments' treatment of particular national groups of foreign firms.[26] From the 1950s to the 1970s, emerging-economy governments frequently broke contracts with ex-colonial foreign investors (Chapter 7). Tanzania openly targeted British-owned banking, real estate, agriculture, and manufacturing for nationalization, just as Algeria targeted French FDI in the oil and gas sector.[27] Today, investment coming from China is highly politicized in Taiwan and a major point of contention between

cultural ties. Meunier, Sophie (presentation, Princeton Workshop on Outward Chinese Foreign Direct Investment, November 2012, Princeton, NJ).

21 Biglaiser and Lektzian 2011, Li and Vashchilko 2010. Lee and Mitchell (2012) find that bilateral FDI has no effect on states' decisions to start interstate conflicts, but higher bilateral flows reduce the probability of violent escalation.

22 Li and Vashchilko 2010.

23 Biglaiser and DeRouen 2006.

24 Desbordes 2010. Davis and Meunier (2011) find that changed relations between advanced industrial countries do not have a significant impact on bilateral FDI flows.

25 Knutsen et al. 2011.

26 Certainly, the idea that firms of particular nationalities can be made vulnerable by high politics is not new: the onset of World War II led to the expropriation of German assets in Allied countries.

27 Akinsanya 1981.

the island's two major political parties; on the other hand, US investors into Taiwan are welcomed heartily and receive informal if not formal preferential treatment.[28] Tendencies to discriminate against particular ethnic groups can also be translated into governmental relations with foreign firms. In Moldova, for example, Turkish investors have found it beneficial to play down their national origins, lest they be targeted for breach in forms like extra-contractual "tax payments."[29]

In the shadow of high politics, change in one nationality's contract sanctity provides little information to investors of other national origins. For example, foreign firms operating in post-communist Europe understand that Russian-origin firms have different relationships with host governments in this region that Russia calls the "near abroad" rather than simply "foreign."[30] Because politics in Eastern Europe is often tied up with host governments' interactions with Russia, political turnover in Eastern European host countries can result in increased or decreased contract risks for Russian-origin firms. These dynamics behind Russian contract sanctity differ from those faced by firms of other national origins invested in the region.

A firm's national origins can also give a host-country government and polity expectations about the contributions the firm's investments will make to local development. FDI provides capital to capital-seeking emerging economies, but it is set apart from other capital flows by the possibility that it will provide technology transfer, spillovers to the domestic economy, managerial and operational know-how, and other direct contributions to the local economy. These gains, however, have often proven elusive. Comprehensive surveys of literature on the effects of FDI provide inconsistent evidence that FDI leads to economic growth.[31] If all FDI is not created equal, host governments and polities have incentives to privilege some firms and types of investments over others. Firms from wealthy Western home countries can carry "national brands" that make host governments expect more reliable knock-on benefits from their FDI than, say, from the FDI of investors from the global South. For example, Ukrainian officials were concerned that "selling an aluminum plant to Russians is not development," preferring instead to sell it to a firm from a European Union member state.[32] Multilateral organizations like the World Bank and European Union have spread the best practice of trying to attract FDI from certain home countries in hopes of gaining broader growth-promoting resources; generally, the targets for investment promotion are Western (although

[28] Meetings with Taiwanese economic development officials and US actors (13), Taiwan, August 2013.
[29] Interview, Turkish firm, Moldova, 2009. Turkish investors do receive good treatment in Gagauzia, a sub-region in Moldova where the local population has Turkish roots. Chapter 6.
[30] In Russian: *лижнее зарубежье*.
[31] E.g., Moran et al. 2005.
[32] Interview, domestic think tank, Ukraine, 2011.

desire for Chinese-origin FDI is growing, particularly in the global South).[33] However, high expectations can lead host governments to break contracts with Western firms if investments do not result in the expected benefits. This dynamic sat behind the cancellation of US and Spanish firms' water and sewage contracts in Argentina and broadly in Asia in the early 2000s, when improvements in service quality (and higher prices) did not match host-government expectations.[34] Local beliefs about the contributions a nationality's FDI will make to domestic development make nationality relevant to the government's mutable expectations of firms and, thus, to firms' contract sanctity.

Bilateral ethnic, linguistic, and cultural ties also differentiate the willingness and ability of host governments to breach contracts with certain groups of investors rather than others. Cultural similarities between home and host countries can reduce transaction costs between foreign firms and the host government, allowing investors to rely less on codified contracts with the host government and more on shared norms and tacit knowledge.[35] Common language and colonial history are standard, positively signed controls in studies of the determinants of FDI, and scholars have found that FDI flows are higher when countries have similar levels of corruption[36] and when countries have similarly egalitarian cultures.[37] Similarly, diaspora ties and cross-border social networks make it easier for firms to operate under informal and incomplete contracts, which changes the nature of diaspora firms' contracts with the host government as compared to firms with arms-length relations.[38] Because tacit and arms-length contracts rely on such different institutions for their maintenance and the resolution of conflicts, the sanctity of one type is necessarily different than the sanctity of the other. Put differently, broken arms-length contracts do not signal the same risks to investor groups that have different sorts of historical and cultural bargains underpinning their government relations.[39] For example, Makino and Tsang attribute the varying treatment firms from France, China, and Hong Kong have faced in Vietnam to variation in formal and informal historical ties.[40] When bilateral ties shape the kinds of contracts firms enter into with the host government, it follows that different national groups face uneven risks to contract sanctity.

Co-national firms can benefit from dense networks of ties built up at home, through commercial interactions, lobbying efforts, shared hometowns, and simply the experience of having operated in the home country. Firms with

[33] Loewendahl 2001. Interview, European Union consultant for Investment Promotion Agencies, Moldova, 2009.
[34] Post 2009.
[35] Williamson 1979.
[36] Wu 2006, DeBacker et al. 2012.
[37] Siegel et al. 2011, 2013.
[38] Bandelj 2008, Leblang 2010.
[39] Hirst and Thompson 1995.
[40] Makino and Tsang 2011.

the same national origin operate in similar ways abroad, embodying the formal and informal institutional constraints of their country of origin.[41] They are more likely to use the same kind of financing for their operations, whether because they use formal institutions provided by their home government, or because they are predisposed to use certain ownership structures by virtue of home country experiences.[42] Commonalities among co-national firms make them efficient sources of local knowledge for each other, able to communicate among themselves in culturally understandable ways.[43] In other words, co-national ties can help firms to overcome what Stephen Hymer termed the "liability of foreignness."[44] Indeed, scholars argue that the greater the separation between home- and host-country cultural norms as well as regulatory institutions, the more difficult it is for a nation's foreign investors to gain legitimacy with the host-country polity and government.[45] Knowledge provided by co-nationals is particularly relevant for firms from national groups that have "a high degree of outsidership" in the host economy, because these firms find it more difficult to establish reliable, trust-based relationships with local actors.[46] Co-national firms can benefit from a "legitimacy spillover" if, for example, early entrants of the same national origin have already had time to cultivate strong government relations.[47]

Because of these many sources of commonality in contract dynamics, national origin becomes shorthand for shared risks to contract sanctity. Investors see co-national firms' broken contracts, worry that they are next, fear for the sanctity of their investment, and therefore are more likely to decide to draw down an existing investment or divert planned investments in response.

Investors of different nationalities, in contrast, are less likely to see a firm's broken contract and fear for the sanctity of their investments. The signal that contract breach sends to non-co-national firms is highly diluted. A non-co-national firm does not share the same bilateral legal institutions. A non-co-national firm's contract sanctity is unlikely to be negatively impacted by the dynamics of the targeted firm's home–host relationship. A non-co-national firm is less likely to have acquired financing in the same way, or written similar contracts, or relied on the same cultural networks as the targeted firm. In short, the targeted firm's broken contract is less likely to provide useful information on the sanctity of the non-co-national firm's contract. Thus, when the targeted firm's contract is broken, rational non-co-national firms are unlikely to expect their own contract risks to change greatly. As such, they are unlikely to update their behavior in ways costly to the host government. From the host

[41] North 1990, Holburn and Zelner 2010, Doremus et al. 1999.
[42] Doremus et al. 1999, Li et al. 2011.
[43] Tan and Meyer 2011.
[44] Hymer 1976.
[45] Kostova and Zaheer 1999.
[46] Tan and Meyer 2011, Wells and Ahmad 2007.
[47] Ibid.

government's point of view, non-co-national firms' reactions are observationally equivalent to indifference. That indifference is what can, in sufficient concentration, enable breach.

NATIONAL ORIGIN AS A RESOURCE

Foreign firms entering emerging economies take measures to protect their investments from political risks, including the risk of government breach of contract. When new risks arise, however, firms have incentives to augment their existing strategies with additional "recuperation mechanisms" in order to recover previous levels of contract sanctity.[48] FDI exit or diversion is the recuperation mechanism that exerts direct pressure on host governments' access to foreign capital. However, from the foreign firm's point of view, exit can be an expensive option of last resort. Firms choosing to exit or divert capital in response to changed risks leave behind sunk capital and incur transition costs.

What is more, the loss of capital may not effectively deter future government breach of contract. Just as there are a multitude of reasons to invest in a host country, there are a multitude of reasons for investors to exit that country. In interviews, executives themselves can be wary of directly attributing investment drawdown to breach, because so many factors are at play in investment decisions. Deterrence might be played out not through investment drawdown but rather when firms change their mode of entry – for example, when firms choose to make further investments in arms-length transactions like subcontracting.[49] Without a consistent and direct tie between breach and exit, host governments may not interpret changes in aggregate FDI statistics as a reflection of their decision to encroach on some contracts. When exit results in relative but not absolute losses of FDI, incumbent governments may continue to benefit from increasing aggregate levels of FDI. As many emerging economies have experienced a secular increase in FDI in the last decades, relative but not absolute FDI decline is pervasive. The complex counterfactual reasoning of what might have been in the absence of government breach makes for a difficult opposition slogan. For these reasons, co-national exit alone may not deter a government from breaking contracts with a national group of investors, because it may not sufficiently affect a host government's ability to remain in and benefit from its position of authority.

However, exercised alongside or in lieu of exit, protest can be a cheap and effective option for foreign firms to recoup contract sanctity. As Hirschman expressed it, protest or "voice" occurs when actors articulate their interests in order to get an organization, or in this case a government, to return to its previous performance. The exercise of protest requires an interested group of

[48] Hirschman 1970.
[49] Henisz and Williamson 1999, Mosley 2011.

actors that has the capacity to lobby through direct or collective action.[50] Exercising protest requires some dedication, as it can be risky. But co-national actors – both diplomats and firms themselves – share resources to overcome obstacles to effective organization and the incentives to protest against breach.

Diplomacy

Co-national firms have unique access to their home governments. Even prior to breach, home governments make forward-looking commitments to their firms' property rights abroad by signing BITs and other investment agreements with host governments. But, should a contract dispute arise, home governments can and do respond in real time, usually before legal proceedings.[51] The existence of a formal BIT can make it easier for a foreign firm to recruit its home government's assistance.[52] "Gunboats" no longer come to the rescue of foreign firms facing broken contracts, if they ever did.[53] But home-country diplomats link firms' contract sanctity to other issues in the bilateral relationship, such that the future costs of lost capital are compounded by the costs of declining bilateral relations and threats to particular issue areas. We can think of this kind of issue linkage as "bracketing": diplomats make threats that inaction on one issue will trigger punishments in another issue area.[54] Governments have often linked other economic issues to the circumstances of particular firms, by threatening bilateral trade relations or foreign aid distribution in retaliation for breach of contract. Security issues can also play a role in a home government's fight against breach, just as they can in a host government's motivations to breach. In general, support from commercial attachés, ambassadors, and home-country politicians gives foreign firms access to their home government's clout with host-government decision-makers. By lengthening the shadow of the future, a home government can elicit cooperation from a host government and increase the credibility of the host's commitments to contract sanctity.[55] In the words of a respondent at an investor-relevant United Nations agency, embassies "make a foreign investment relationship visible, so it is known that something will be a problem."[56]

[50] Hirschman 1970.

[51] The ICSID convention suspends the right of diplomatic protection during the arbitral process (Article 27) but "resurrects that right" if and when state has "failed to abide by and comply with" an award as obligated to do under the convention (Article 53). Bishop 2009: 6.

[52] Interviews (2), former US government officials, Washington, D.C., 2009. Büthe and Milner 2009.

[53] Tomz 2007, Lipson 1985, Wells and Ahmad 2007. But see Mitchener and Weidenmier 2010.

[54] Oye 1992; Lohmann 1997, Davis 2004.

[55] Diplomacy can extend to the enforcement stage after an IA award is made. Under some BITs, the home government could initiate arbitration if the host government refuses to comply with the award, or the home government could bring a claim before the International Court of Justice. Bishop 2009, 14.

[56] Interview, United Nations agency, Moldova, 2009.

The empirical record shows that co-national actors regularly draw on home-country officials and institutions to respond to threats to contract sanctity. Even at the turn of the twentieth century, US politicians came out in support of US firms facing disputes abroad. In his first "annual message" in 1909, William Howard Taft talked about putting pressure on Chile when "diplomatic intervention became necessary to the protection of the interests" of a particular US firm.[57] Since then, the United States has legislated issue linkages between the status of foreign firms abroad and other aspects of the bilateral relationship, pre-emptively creating tools for diplomatic leverage. The "Hickenlooper Amendment" to the Foreign Assistance Act of 1962, for example, required the US government to suspend foreign aid to countries that expropriate US property without just compensation. The Amendment came about in response to mass Cuban expropriation of US property and fears that similar actions could take place again. However, formal sanctions were applied only once in Ceylon (Sri Lanka) and the Amendment was repealed in 1972.[58] American firms, in fact, felt that the diplomatic threat was too strong and pushed for a softer – though by no means absent – US government hand in contract disputes.

Indeed, built-in threats to deter breach are still present in the American diplomat's toolkit. For example, in 1994 the "Helms Amendment" prohibited US foreign aid or US approval of international financial institution financing to countries that have expropriated property in which US citizens hold at least 50 percent ownership. The United States invoked this Amendment and delayed a US$175 million Inter-American Development Bank loan to Costa Rica until Costa Rica consented in 1995 to an IA with a US firm.[59] The 2000 African Growth and Opportunity Act and the 1991 Andean Trade Preference Act also allow the government to withhold benefits from countries facing outstanding American expropriation claims.[60] And, to be eligible for the Generalized System of Preference (GSP), an important source of benefits for US trading partners, a host country has to be free of expropriation claims from American firms. This is the linkage that led the United States in 2012 to withdraw GSP benefits in retaliation for Argentina's non-payment of two US firms' IA awards, which themselves dated back to breach of contract during Argentina's 2002 default (Chapter 1).

[57] "Many years ago diplomatic intervention became necessary to the protection of the interests in the American claim of Alsop and Company against the Government of Chile. The Government of Chile had frequently admitted obligation in the case and had promised this Government to settle ... Now, happily, as the result of the recent diplomatic negotiations, the Governments of the United States and of Chile ... have agreed by a protocol to submit the controversy to definitive settlement by His Britannic Majesty, Edward VII." Taft, "First Annual Message," 7 December 1909. Described in Veeser 2002.

[58] For a discussion of diplomatic positions taken by US embassies at the time, see Behrman et al. 1975: 84–89.

[59] Helms Amendment: 22 USC sec. 2378 a. (30 April 1994). As reported in *Compañia del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica (ICSID ARB/96/1)*.

[60] Wells 2005: 442.

In 2012, the role of home-government involvement in one nationality's investments abroad became quite explicit. President Putin of Russia issued a decree that certain Russian multinationals must get approval from the Kremlin before complying with foreign investigations and court or administrative orders in host countries. Whether they are public or private firms, "strategic" Russian multinationals in oil and gas, telecommunications, media, finance, and other major industries will not be given permission to comply by the Russian government if "compliance would be deemed detrimental to Russian economic interests."[61] Certainly, this decree is of questionable legality and enforceability. Yet whether the Kremlin exercises this authority or not, the sentiment behind the decree sets the legal risks surrounding contracts with Russian multinationals apart from the risks surrounding contracts with other firms. It also suggests that the Russian home government is more than willing to come to the aid of its nationals' firms abroad, both pre-emptively and in the course of a dispute.[62]

Home governments have an important role to play in deterring contract breach, but diplomats are not always willing or able to come to their nationals' aid in contract disputes. From the home government's point of view, pursuing a national's dispute could use up political capital better spent on other aspects of the bilateral relationship. Or, points of leverage like issue linkages may not be readily apparent. If there is already a BIT in place, home governments have made a prior effort on behalf of their firms abroad and might be less willing to engage in real-time support once a BIT violation arises. On the other hand, BITs can facilitate a home government's formal diplomatic representation (démarche) on behalf of its firm in a host country. Some firms carry enough influence in their home countries to get reliable access to diplomatic resources, whether formal or informal. And home governments that push for better treatment in response to threats to their nationals' contract sanctity today can save resources that would otherwise have been spent on other, future disputes. Any one firm's problem, however, need not constitute a diplomatic priority.

Because diplomatic pressure in a given contract dispute is not certain, co-national firms' ability to come together and lobby their home government for support is an important determinant of diplomatic involvement. Firms of the same nationality can benefit from previous shared interactions with the home country government to successfully access diplomats. But even the largest of a home country's firms in an emerging economy increases its leverage over a home government when it builds a coalition of co-national firms, as a coalition keeps a firm's dispute from being dismissed as the problem of only one.[63] Formal

[61] Greene, Sam, "A Rare Moment of Policy Transparency in Russia: Why the Government Just Ordered Companies Not to Obey Laws," *The Monkey Cage*, 13 September 2012. Russian Presidential decree: "Указ о мерах по защите интересов России при осуществлении российскими юридическими лицами внешнеэкономической деятельности," issued 11 September 2012.

[62] See Chapters 5 and 6 for examples.

[63] Olson 1965.

and informal co-national investor associations, which are common around the world, allow co-national firms a platform from which to advocate for diplomatic intervention to restore their collective contract sanctity. What is more, co-national firms can and do use such organizations to come together and lobby host governments directly.

Co-National Protest

Diplomatic efforts regularly take place alongside collective action by co-national firms. Foreign firms are often highly visible players in emerging economies, which, combined with lobbying experience from their home countries, can make them influential in emerging economies' sometimes underdeveloped lobbying environments.[64] Groups of co-national firms have often already overcome collective action problems in forming formal or informal nationality-based investor organizations that can facilitate protest. Pre-existing formal and informal ties between co-national firms help to increase the effectiveness of their commitment to mutual support. Thus, even before protest takes place, co-nationality can send a signal to the host government that, should a contract be broken, these co-national firms are likely to take costly action in response. Should a government attempt a contract breach, co-national firms have the incentives and resources to organize what can be effective campaigns. In 2009, for example, Chinese policymakers took an American light manufacturing firm's products off the market and left competing local products untouched. This would have effectively kept the firm from operating in China. After advocacy from American diplomats and lobbying via American investor associations, the decision was reversed.[65]

One can think of the dynamic between co-national firms in terms of military alliances. Like the presence of an alliance, nationality increases the probability that each firm will intervene on another firm's behalf.[66] The shared good of contract sanctity among co-nationals gives the "alliance" teeth and incentivizes co-nationals to act collectively in response to each other's broken contracts. In the words of an Argentinian official, "Foreign investor associations like the American Chamber of Commerce fight, but they fight their own fights."[67]

Yet just as diplomats do not always lobby for their nationals, firms do not always engage in co-national collective action. Firms incur costs when taking a public stand, such as tarnishing their reputation with the government, local suppliers, or the domestic population. To offset the potential costs of protest, co-national firms must have an expectation that their efforts will be successful.

[64] Desbordes and Vauday 2007.

[65] Interview, US firm, Washington, D.C., 2010. The future chair of the Shanghai American Chamber of Commerce understood the importance of co-national lobbying when he said the organization must "make our voice heard in the halls of government … [and] improve business conditions *for members*." Emphasis added. Jensen et al. 2012: 116.

[66] Morrow 2000, Fearon 1997.

[67] Interview, Germany, 2009.

Consistent with the argument throughout this book, diplomatic and co-national protest is likely to provide a strong shield against breach when FDI national diversity is low, but protests are quieter and the shield is weakened when FDI national diversity is high. This prediction helps to account for cross-national variation in, for instance, the mission and strength of US investor institutions. As we see in Chapters 5 and 6, the American Chambers of Commerce in more homogenous Moldova and Ukraine have fought directly for members' contract sanctity while, in contrast, the American Chamber of Commerce in diverse Romania has focused more on networking activities.[68] I take the correlation of such variation with FDI national diversity as an additional piece of evidence for the nationality shield theory.

"TRUE" MULTINATIONALS AND TAX HAVENS

Before considering the effects of national diversity at the level of the economy as a whole, I stop here to consider: if nationality matters for multinational firms, what about firms that have roots in multiple home countries? Mergers and acquisitions leave some multinationals with more than one set of national ties, and sometimes firms invest in third countries via second country subsidiaries. The steel giant ArcelorMittal, for example, has British, French, and Luxembourgian ownership, and it invested in Ukraine via its well-established subsidiary in Germany (Chapter 5). Such multinationals are often seen as the world's most powerful holders of leverage over host governments.

Firms also take advantage of the secrecy and lax regulations of tax havens, sometimes known as offshore financial centers, when engaging in FDI. Those most commonly agreed to be tax havens include household names – the Bahamas, Bermuda, and the Cayman Islands – although Palan et al. identify ninety-one jurisdictions labeled tax havens by different governmental and non-governmental bodies.[69] These include Malta and Cyprus as well as the Netherlands, Switzerland, and in some cases, the United Kingdom and the United States. Tax havens are more likely to be "pass-through" countries for FDI, though certainly not all FDI passes through, as some tax havens are also major destination countries for FDI. To make matters more complicated, a subset of capital taking advantage of tax havens comes from "host" countries themselves. That is, Chinese capital flows through Hong Kong and some of it back to China and, as we see in Chapters 5 and 6, Eastern European firms sometimes use Cyprus as a location through which to "round-trip" capital.

One might question whether firms investing via subsidiaries, in tax havens or otherwise, pick up characteristics of the pass-through nationality. I contend that, far from existing outside of national boundaries, "true" multinationals and tax

[68] American Chambers of Commerce determine their mission and activities very much on a local basis, especially those outside of Western Europe. Interview, Washington, D.C., 2012.

[69] Palan et al. 2010. Chapter 7.

haven investors are made vulnerable to contract risks associated with more than one bilateral relationship. By choosing to involve an intermediate country in a firm's aggregated nationality, a firm exposes itself to vulnerabilities or preferences afforded investors from that intermediate country in the ultimate destination country.

Firms investing via the same intermediate home country share many similar determinants of contract sanctity, just as firms from the same traditional home country do. Domestic laws in the intermediate country shape the kinds of contracts firms can enter into with ultimate host countries in ways unrelated to those faced by traditional foreign investors. For example, preferential Double Taxation Treaties (DTTs) can give these investors tax privileges and simultaneously potential contract vulnerabilities if the host polity sees those deals as too lucrative ex post. Moreover, intermediate homes that require low levels of disclosure or due diligence may allow firms more flexibility in contracting with host governments. This, too, translates into different contract vulnerabilities should flexible relationships turn sour. Taking institutions into account, the legal rights available to intermediate home firms are a product of both their ultimate home and of their intermediate home. For example, there is legal precedent that firms invested in intermediate homes have access to that country's BIT if the intermediate home investment is robust enough.[70] As a result of such factors, firms investing via a given intermediate home are likely to be interested in the fate of contracts made by similarly invested firms, just as they are likely to be interested in the fate of contracts made with firms of their ultimate home nationality. In Chapter 5, for example, we see that Russian firms investing in Ukraine via Cyprus-incorporated entities look to each other and to the Russian government when evaluating their political risks.

Whether or not firms with intermediate firms can access multiple (or any) sources of diplomacy is not ex ante clear, but what is clear is that the diplomatic access afforded to one intermediate home firm is more likely to resemble that afforded to other firms with claims on the same combination of countries. Firms with claims on more than one home country can have access to multiple sets of diplomats that advocate around contract breach: ArcelorMittal in Ukraine benefitted from advocacy by France, the United Kingdom, Germany, and Luxembourg (Chapter 5). However, firms' access to diplomats is not unconditional. For example, the ability to access both intermediate and ultimate home-country diplomats may be undermined if the decision to invest via second countries has negative political connotations at home. Diplomats from the Bahamas and the Cayman Islands have proved unwilling to advocate on behalf

[70] The 2004 jurisdiction decision in *Tokios Tokeles v. Ukraine (ICSID ARB/02/18)* provides the (non-binding) precedent for this access. To be heard at ICSID, a complainant must be a national of an ICSID country and not a national of the host country. ILA German Branch/Working Group, *The Determination of the Nationality of Investors Under Investment Treaties – A Preliminary Report*, December 2009.

of particular firms' broken contracts in FDI destination countries, though these governments' commitments to maintaining secrecy provisions may de facto aid firms in fighting breach.

In short, the nationality shield theory and evidence in this book go to show that firms with multiple national identities do not become meta-national.[71] Rather, a "true" multinational firm is most likely to receive signals about and advocacy for its own contract sanctity from (only) those multiple national groups to which it belongs.

FDI NATIONAL DIVERSITY

Firms' perceptions of risks to their contract sanctity vary with national origin, and this variation shapes firms' willingness to exit in response to breach of contract as well as their ability to wield protest to deter breach. When considered at the level of the host economy as a whole, we see that foreign firms' reactions to breach with any given firm are not uniformly costly to the host government. Rather, costliness is conditioned on the nationality of the targeted firm and the nationalities of other firms. Although firms of the targeted nationality exit or generate diplomatic costs for the host government, other foreign firms' investment plans and interactions with the host government are likely unchanged. Non-co-nationals' behavior is thus likely to be observationally equivalent to indifference to a given breach. As a more nationally diverse set of firms presents alternative sources of current and future FDI to the host country, any one nationality's costly response is less likely to constrain the host country's overall access to foreign capital.

The nationality diversity of the investor community in a host country takes into account two factors: the number of national investor groups present in the host country and the distribution of existing FDI stock across national groups.[72] The absolute number of national groups matters particularly for the host country's future access to FDI. Even if a given national group invests a small amount of FDI today, the fact that firms of that nationality have already entered makes that national group a more reliable source of capital tomorrow than another, as-yet-unrepresented nationality. As the sales adage goes, it is easier to grow a client than to get a client.

The second component of FDI national diversity is the distribution of accumulated FDI stock across nationalities. Suppose a country hosts two nationalities of foreign firms. When each group accounts for half of the country's FDI, the host government has an alternate, ready source of FDI that can help

[71] Undercounting these hybrid groups in conventional FDI data makes it harder to demonstrate the theorized, positive effect of FDI national diversity on breach. Chapter 4.

[72] In quantitative analysis, I use: FDI national diversity = $1/(s_{1t^2} + s_{2t^2} + s_{3t^2} + \ldots + s_{nt^2})$ where s_n is nationality n's share of the annual FDI stock from OECD countries to country i in year t. This is an inverse Herfindahl-Hirschman Index. Chapter 4.

compensate for lost capital were it to breach with either group. But when one nationality represents a very large share of FDI stock, breach of contract with that group would threaten the country's main source of FDI, effectively reducing the probability of its breach as well as breach in the economy overall. Because risks to contract sanctity are overwhelmingly bilateral, breach with the second, smaller national group would not be a substitute for breach with the large group; breach with it would also be costly in reducing the diversity of capital available to the host economy. In fact, the likelihood of breach would be inversely related to size if breach with smaller national groups is less likely to bring about the kind of benefits host governments desire from breach.[73] Many variables determine the size or thickness of any particular nationality shield, and the level of FDI national diversity does not in itself suggest which firms or contracts may be targeted for breach. Rather, the expectation is the more even the distribution of FDI across national groups, the higher the likelihood that the government can act on its incentives to breach where it would like to, somewhere in the economy as a whole.[74]

CONSIDERING INDUSTRY EXPLANATIONS

Often, industry springs to mind when we think about variation among firms. How do arguments about the effects of co-nationality align with expectations about industry and contract risks? Literature beginning with Vernon points to the importance of industry in determining which firms might be more likely targets for expropriation. Vernon's "obsolescing bargain" logic posits that foreign firms hold the upper hand in negotiations before entering a host country, but after investors incur sunk costs, the host government is tempted to violate its contractual commitments.[75] Governments can take over productive investments from firms that cannot easily move (all of) their assets elsewhere. Vernon put it poetically: "Almost from the moment that the signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eyes of the government."[76] The more sunk costs a firm incurs, the less mobile the firm, the less credible the firm's exit options, and thus the less credible the government's contractual commitment.[77]

Observers usually turn to industry to identify which firms are those unlucky, immobile ones.[78] Expropriation is often associated with oil installations, gold

[73] As explored in Chapters 2 and 4, we see empirically that both large and small investors have been targets of government breach of contract.

[74] Indeed, if every nationality has only a single firm investing at the same amount, extreme national diversity will leave firms no co-nationals to fight breach through collective action.

[75] Vernon 1971.

[76] Ibid.: 47. Despite the obsolescing bargain, successful investors are enticed to remain in the country "by the sinking of commitments and by the sweet smell of success" (53).

[77] Moran 1973.

[78] Wolf 2004, Henisz 2002.

mines, electricity transmission grids – assets with owners that are hamstrung by their industries' sizes, shapes, and capital intensity. Frieden determines that site-specific investments, which are easily seized and for which rents are concentrated, are subject to extensive initial sunk costs.[79] The particular vulnerability of site-specific investments helps to explain cases like the changing relations between Namibia and the diamond giant De Beers,[80] the early 1970s copper firm nationalizations in Zambia and Zaire,[81] oil and gas nationalizations,[82] and even the struggles of relatively immobile manufacturing firms in India.[83]

Scholars have extended the obsolescing bargain framework in various ways, using it to model trends in expected future returns for foreign firms over time;[84] to account for the bargaining between home countries, host countries, and multilateral institutions that sometimes precedes private FDI;[85] to explain the role non-governmental organizations (NGOs) can play in international investment;[86] or to justify new contractual clauses that attempt to take account of the dynamics of investor–host government relations.[87] Throughout these applications and extensions, however, the backbone of the argument remains that immobile firms have more vulnerable contracts than other, mobile firms.

However, industry and asset mobility fail to fully explain the permissive space governments have to sometimes break contracts for five main reasons. First, firms' investments are in fact not so readily segregated into mobile and immobile groups along industry lines. More and more contemporary foreign firms across many industries find themselves stuck in the locations they choose. Some firms are tied to particular host countries through social networks, as in diaspora investment.[88] Bandelj argues that executives draw on social networks and cultural understandings to undertake foreign investments.[89] If one accepts that entry into a historic homeland is a firm's primary motivation in investing abroad, these firms, too, are relatively immobile and subject to the obsolescing bargain. For firms using host countries as export platforms in a world of deverticalized production, a change of location entails a reorganization of supply chains. And for FDI seeking local market entry, significant assets are sunk into retail and distribution networks, not to mention that a change in

79 Frieden 1994.
80 Kempton and Preez 1997.
81 Shafer 1983.
82 Hajzler 2012.
83 Vachani 1995.
84 Thomas and Worrall 1994.
85 Ramamurti 2001.
86 Nebus and Rufin 2009.
87 For example, Land (2009) discusses the use of dynamic contractual clauses like progressive taxation that allows for a "fair" reallocation of assets over time given changing circumstances.
88 Leblang 2010, Graham 2014.
89 Bandelj 2008.

location would entail a major change in firm strategy. Sometimes, local market entry is about capturing remaining market share in the world. For example, Western European banks have been expanding into Eastern Europe, and their investments have not necessarily been chosen for immediate efficiency but, rather, because executives increasingly feel that they have "nowhere else left to go."[90] Accordingly, even investors in banking – a quintessentially mobile industry – are rendered less mobile and more vulnerable to contract risks. Given that so many firms' threats of exit are compromised across and within industries, a focus on industry alone makes it difficult to understand why breach does not always occur.

Second, even investors in classically vulnerable industries can cancel planned projects or stop reinvestment in a host country. An oil firm's threat to stop new exploration or a mining firm's threat to stop operations is credible, because capital not yet deployed is still mobile. Thus, the bargaining power of such firms is not fated to wholly obsolesce as firms retain leverage traditionally associated with mobile investors.[91] And the spread of risk management strategies – from bodyguards, to diversification across geographies, to political risk insurance, to book-sized contracts – lead firms in traditionally immobile industries to feel they can sufficiently account for contract risks upon entry into a host country. Now, firms certainly have interests in updating their expectations of government breach of contract once disputes occur in a host economy. Indeed, this logic underlies both the conventional wisdom and this book's twist on the costly responses host governments face when engaging in breach of contract. But innovation in risk management has allowed traditionally immobile investors to mitigate at least some of the vulnerabilities that the obsolescing bargain suggests.

Third, consider how a given firm might react following a breach of contract somewhere in its industry. Following a breach, co-industrial firms may find new investment opportunities: a competitor's broken contract could be a boon for their local business prospects. Because firms in the same industry might perceive both risks and opportunities following a co-industrial's broken contract, it is unclear ex ante that a co-industrial firm would react to a given breach by diverting or drawing down its own capital. Indeed, there is reason to believe co-industrial firms might even increase investments in response. After Argentina nationalized the Spanish oil and gas firm Repsol in 2012, for example, firms from the United States, China, and Norway expanded investments in the sector. Further, countervailing competitive pressures suggest that co-industrial firms are unlikely to take a stand on behalf of a competitor. The benefits to any formal or informal industry organization of "staying out of it" are likely to outweigh the

[90] Lanine and Vander Vennett 2007. Interviews (4), foreign banks, Ukraine, Romania, and Moldova, 2009.

[91] Likosky 2009.

benefits of spending political capital on one firm's problem.[92] In contrast, because co-national organizations are made up of non-competitors (at least in part), they are not by necessity strained by the same countervailing pressures.[93]

The fourth and fifth reasons industry is insufficient to explain breach are empirical. As is shown throughout this book, contracts continue to be broken both inside and outside of traditionally immobile, obsolescing bargain industries. And, since motivations behind government breach of contract have been about raising revenue, specific assets, foreign policy, domestic audiences, corruption, and more (Chapter 2), it is not obvious that breach of contract with a firm in an immobile industry is the best way to achieve any of these various goals.

These arguments aside, breach of contract can sometimes be in response to sector-specific motivations. In such cases, industry would be a focal point for investors' perceived contract risks. Can an "industry shield theory" thus explain variation in sector-wide breach? For "co-industrial" firms to benefit from a shared shield, they would have to react in ways costly to the host government following a breach in the sector. Costly reactions could take two forms: the differential drawdown of capital by firms in the same industry and co-industrial protest against breach. If an industry as a whole is a target of breach, however, the government has effectively decided that the drawdown of FDI within that industry is a goal rather than a cost. Thus, a "shield of industry" would have to be born of common protest that could impose enough costs on a host government to make it change its behavior. Put bluntly, it is unlikely that protest by exactly the population of firms the government is targeting would make the government change its mind.

In fact, the nationality shield theory implies that responses to breach will still operate along co-national cleavages even when cross-national action seems more logical. By implication, we should see co-national protest even when a whole sector is targeted. Why? Co-national firms enjoy diplomats and nationality-tied investor organizations that can be willing and able to align against contract breach. As one example of co-nationality trumping co-industry, a Western European manufacturer in Ukraine drew on embassy support as well as groups of co-national foreign firms to stop legislation that would discriminate against its international trademarks. While the legislation was industry-specific, diplomats and co-national organizations advocated against the legislation, fearing for the integrity of their nationals' marketing campaigns in Ukraine more generally. The CEO of the targeted firm complained that industry-based lobbying (by firms of

[92] Industry organizations would be more likely to spend their political capital on common issues, like lobbying over industry-wide tax rates and regulatory obligations.

[93] Of course, co-national firms might also be co-industrial firms. It is an empirical question as to whether such firms are willing to coalesce in support of their compatriot. The analyses in this book provide evidence to establish that nationalities do not have a one-to-one correspondence with industries in host countries.

various nationalities) was, in contrast, weak and ineffective.[94] As we will see again in Chapters 5 and 6, industry need not provide the resources that nationality can.

Industry can provide a focal point for investors, but it does not come along with the ex ante expectation that co-industrial actors will pull down investment and engage in protest in ways that are costly for a host government. FDI industries (or their diversity) are not a sufficient determinant of the space governments have to break contracts. By controlling for possible industry effects throughout the empirical sections of the book, I find that nationality is a crucial – though heretofore overlooked – factor.

SHIELD OF NATIONALITY

Many studies of contracting relationships explain variation in compliance under "renegotiation-proof" contracts, effectively defining away the conflicts addressed here. Indeed, from this point of view, government breach of contract with foreign firms is off-equilibrium path behavior. Work that explains off-equilibrium behavior has on the whole been applied to contracts between private actors.[95] However, the concept of private–public contracts between foreign and domestic actors raises a unique issue: one party to the contract has the sovereign ability to act outside of a contract and above the rule of law, whatever the contracted terms. Put differently, states have the ability to breach even the elusive "perfect" contract with a foreign firm in a way that private actors contracting under commercial law do not.[96] This book can be seen as advancing understanding of the behavior of sovereigns in contracting with private parties. When are governments constrained to honor contracts that are not renegotiation-proof, and when should we expect off-equilibrium behavior in investor–host government relations?[97] To answer these questions, this book looks at the effects of third-party pressure – from other firms, investor organizations, and diplomats – on a government's respect for any given contract.

Under economic globalization, the expectation has been that third-party foreign firms in large part generate informal property rights enforcement, because FDI diversion follows from contract breach. Consistent with this claim, co-national actors can and do exert power over a host government that considers breaking a contract with a given foreign firm. But third parties of other national origins are unlikely to act in ways costly to a host government following breach with a non-co-national. By starting from the behavior of firms and

94 Interview, Ukraine, 2011.

95 Williamson 1979, Ahlquist and Prakash 2009. For an example at the inter-state level, see Pelc (2010) for an explanation of why efficient breach is underprovided at the WTO.

96 Economics scholars have modeled the conditions under which breach of private contracts is efficient. E.g., Simpson and Wickelgren 2007, Stremitzer 2010.

97 For models of contracts that allow for equilibria in which expropriation occurs with a positive but stochastic probability, see Eaton and Gersovitz 1984, Cole and English 1991.

aggregating to the level of the economy as a whole, we see that the informal enforcement of FDI contracts with host governments relies disproportionately on co-national action. Even firms of the same industry need not band together to impose costs on host governments following breach of contract with co-industrial firms.

Foreign firms of the same national origins share risks and resources that make their response to co-national breach punitive, particularly so when FDI national diversity is low and their actions have a greater influence on the host government's access to capital. Indeed, when an increasingly diverse set of foreign firms is present in a host country, the government gains more permissive space to breach contracts with one national group without threatening the contract sanctity of other groups. Put plainly, the greater the national diversity in a host country's population of foreign firms, the higher the likelihood of government breach of contract.

Taking exposure to more bilateral FDI relationships as an indicator of economic integration, the nationality shield theory challenges the conventional wisdom that the development of private property rights protections moves together with economic globalization. Far from having faded from relevance in a world of economic globalization, bilateral relations play a major role in shaping foreign firm and diplomatic interests in responding to breach.

In fact, as the world continues to integrate economically, the signaling power of nationality when it comes to contract sanctity should continue to increase. Foreign direct investors use information to maximize expected returns, but they are constrained by the costs of collecting and acting on information.[98] With more investment opportunities comes more information, and market participants have no choice but to economize more on information processing.[99] Already, firms have a plethora of incentives to look toward the status of co-nationals' contracts to understand their own contract sanctity. As more and more opportunities open up in emerging economies, economizing on information will only reinforce these incentives to look to co-nationals. Today and in the future, national diversity can be a liability to firms and an opportunity for host governments to exercise autonomy even in a globalized world.

[98] Mosley 2000, 2003.

[99] Calvo and Mendoza 2000.