

**When Governments Break Contracts: Foreign Firms in Emerging Economies**

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Submitted to the Department of Political Science in partial  
fulfillment of the requirements for the degree of

Doctor of Philosophy

at the

Massachusetts Institute of Technology

June 2012

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### ABSTRACT

Emerging economy governments commit to protect the property rights of foreign firms through a variety of contracts, from treaties to direct agreements. In an era of liberalized capital flows, these contracts are thought to be self-enforcing: the fear of capital exit compels governments to honor their obligations. But extraordinary variation in contract sanctity in countries around the world suggests the inadequacy of this view. This dissertation seeks to explain the varying pressures on emerging economy governments to honor or break contracts with foreign firms.

I find that foreign firms' national origins play a key role in their contract sanctity. Firms of the same nationality are more likely to share political risks thanks to a variety of institutional and historical factors specific to the home-host country relationship. Co-national firms can also uniquely access diplomatic support. Shared risks and resources make firms more likely to act in ways costly to the host government when a co-national firm's contract is broken. In contrast, firms are likely indifferent to breach with firms of another nationality. These firm-level reactions generate a counterintuitive result in the host country as a whole. The more diverse foreign firms' national origins, the more space a host government has to compromise one national group's contract sanctity without threatening broader capital access.

Using quantitative analysis, I demonstrate that firms differentially draw down FDI after government breach of contract with co-national firms. I also use over 130 interviews with foreign investors in Ukraine, Moldova, and Romania to demonstrate that co-national actors' protests are stronger and more effective when the foreign investor community is less nationally diverse.

The theory offered here takes seriously the bilateral relationship embedded in each foreign investment transaction. Far from having faded from relevance in a world of economic globalization, bilateral relations shape foreign firm and diplomatic responses to breach. Because host governments breach contracts with certain foreign firms and are met with indifference by others, nationality diversity can be a liability to investors while providing an opening for governments to prioritize other goals over the property and preferences of foreign capital.

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## Acknowledgements

This research was assisted by an award from the Eurasia Program of the Social Science Research Council with funds provided by the State Department under the Program for Research and Training on Eastern Europe and the Independent States of the Former Soviet Union (Title VIII). Additional support was provided by the Harvard Center for European Studies, the MIT Center for International Studies, the Kyiv School of Economics, the Danyliw Research Center at the Chair of Ukrainian Studies at the University of Ottawa, and the Production in the Innovation Economy project at MIT.

Sincere thanks for feedback on the project over the years goes to Nathan Jensen, Juliet Johnson, Kathryn Hendley, Beth Simmons, Jim Alt, Ken Shepsle, Jennifer Tobin, Jens Hainmueller, Teppei Yamamoto, Edward Steinfeld, William Pomeranz, Phil Arena, Cynthia Buckley, Tsveta Petrova, Jordan Gans-Morse, Pey-Yi Chu, Stephen Chadouin, and many others at conferences and workshops along the way.

At MIT, I could not have made it through without the support of my colleagues and friends. Special thanks go to Erica Dobbs, Gustavo Setrini, Hanna Breetz, Timea Pal, Gabi Kruks-Wisner, Paco Flores, Phil Haun, Gautam Mukunda, Joyce Lawrence, and Josh Shiffrin. The support of Greg Distelhorst and Jonas Nahm has meant more than I can say.

I thank my dissertation committee members: my chair Suzanne Berger, David Andrew Singer, and Kenneth A. Oye. I have never had mentors like these. Ken steered me in new and fascinating directions during my first years at MIT. Under his guidance, I have indulged my inner nerd while working with the science and engineering side of the Institute. I value his creativity, his approach to teaching, and his friendship. Suzanne Berger taught me how to wrangle large projects, how to interview executives, how to save myself from getting lost in the weeds. I am grateful for having had so many opportunities to work alongside her, especially in our travels to the disparate locations of France, China, Ohio, and Arizona. I rely on her support and compassion. I have gone to David for daily advice for many, many days now. It is hard to summarize what this has meant to me. Without him, my career would not be on the path it is. It will take some time to get over my sadness when I am no longer down the hall from him.

I thank my intrepid sister Emily for her friendship, through ups and downs. I thank my dear brother Kurt and his growing family. And my parents – I thank them for contributing so much to my life. My Mom's generosity is overwhelming. And the hours and hours I spend on the phone learning from and laughing with my Dad are nowhere near enough.

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## Chapter 1: Introduction

Argentina chose to stop paying its bills when it faced economic crisis in the early 2000s. Dozens of multinational corporations with government contracts responded by suing the state. By March 2012, Argentina was six years overdue in paying two of the biggest resulting awards, totaling US\$300 million, to a US gas transmission firm and a US water services firm. President Obama suspended US trade benefits for Argentina, linking the status of bilateral trade to Argentina's treatment of two particular US foreign investors.<sup>1</sup>

As the conventional wisdom would have it, governments in emerging economies do everything possible to reassure foreign firms. At a minimum, governments respect the contracts they make with foreign firms. To do otherwise would bring on widespread capital flight and diplomatic turmoil. Yet despite such predictions, the Argentine government's decision to break its contracts with foreign firms is anything but extraordinary. Governments around the world have sometimes nationalized, expropriated, or eaten away at the value of foreign-owned property.

In summer 2009, for example, the Ukrainian Parliament shut down the country's entire gambling industry after a deadly fire in a Russian-owned casino.<sup>2</sup> The Estonian-owned Olympic Entertainment Group (OEG) shuttered its casinos, as ordered. But Ukrainian- and Russian-owned casinos, including casinos owned by the Russian firm in

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<sup>1</sup> Texas water services company Azurix petitioned the US government to withdraw Argentina's trade benefits as early as 2010. "Azurix calls for action against recalcitrant Argentina." *Global Arbitration Review*: 29 September 2010. The Argentine government argued that payment "would violate federal law." Palmer, Doug. "Obama says to suspend trade benefits for Argentina." *Reuters*: 26 March 2012.

<sup>2</sup> As reported by a prominent Estonian newspaper, political fights over who could distribute very profitable gambling licenses prompted the disproportionate shutdown. Brettell, Ashley. "Olympic Cashes in Ukraine Chips." *The Baltic Times*: 15 July 2009.

question, operated freely.<sup>3</sup> OEG was in a bind: it could not legally reopen, but it knew that “almost half” of the country’s casinos were open just one day after the official shutdown.<sup>4</sup> OEG soon liquidated its assets and sought compensation from Ukraine, citing Ukraine’s violation of its treaty commitments to fair and non-discriminatory treatment of Estonian firms.<sup>5</sup> In selectively enforcing the gambling ban, Ukraine, like Argentina, violated commitments it had made to protect foreign-owned property.

In emerging economies around the globe, and in a wide variety of industries, we see foreign firms facing host government violations of their property rights. The government of India’s Maharashtra state contracted with the US firm Enron to build a US\$2.8 billion power station, but Maharashtra cancelled the project in 1995 after investments were well underway. Earlier that year, Enron had pulled out of a power project in Colombia after the government there revoked Enron’s tax exemptions and added a 20 percent electricity surcharge after investment had begun. Alongside political turnover in 1999, the Indonesian government broke contracts made with US energy firms.<sup>6</sup> In Uzbekistan, the Korean firm Daewoo invested in a textile firm in the mid 1990s, but the government nationalized Daewoo’s share after the firm achieved a leading position in the Uzbek cotton industry. 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 Turkmenistan in 2005, the government

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<sup>3</sup> The firm, Metro Jackpot, is owned by Ritzio Group, which is controlled by Russian oligarchs Oleg Boyko and Boris Berezovsky.

<sup>4</sup> “Estonia’s Olympic Hoping to Reopen Ukrainian Casinos.” *Baltic Business Daily*: 18 May 2009.

<sup>5</sup> Ultimately, a settlement with OEG took place out of court. Interview, Ukrainian law firm, Ukraine.

<sup>6</sup> Wells 2007.

unilaterally suspended deliveries of a key input, polypropylene, to the Japanese firm Itochu, with the justification that the price paid by Itochu was lower than current market prices. In 2004 to 2005, the Namibian government expropriated German-owned farms; the judiciary there found the government's actions illegal, but in Zimbabwe the government faced no domestic sanctions for its nationalization, or "indigenization" in local parlance, of British-owned farms. 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.

The overwhelming majority of emerging economies has seen a long-term increase in foreign direct investment (FDI), which reached new heights in the 1990s and 2000s. Governments are entering into more and more contracts with foreign firms.<sup>7</sup> Yet the overwhelming majority of emerging economy governments has sometimes violated foreign firms' property rights, generating sizeable variation in how governments treat foreign firms in emerging economies.<sup>8</sup> In the 1990s and 2000s, governments in some 94 countries nationalized at least 150 investments and faced over 310 public, international investment arbitrations (IIAs) in which foreign investors sue the host government for unlawfully devaluing their holdings.<sup>9</sup> These legal actions represent only a slice of what one multinational executive called pervasive instances of "everyday breach of contract."<sup>10</sup>

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<sup>7</sup> In this dissertation, the following are interchangeable: foreign investor, foreign firm, and multinational corporation. Some sources refer to this type of firm as a "transnational corporation."

<sup>8</sup> In this dissertation, "emerging economy" refers to all countries except those that were members of the OECD before 1994. Turkey is an exception and is also included as an emerging economy. Other sources might refer to this group of countries as both "middle-income" and "less developed" countries. The presumption is that emerging economies tend to face capital scarcity and to be capital-importers.

<sup>9</sup> Hajzler 2011, Minor 1994. United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). Accessed January 2012. <http://www.unctad.org/iiadbcases/>.

<sup>10</sup> Interview, foreign firm in financial services sector, Moldova, 2009.

In an era of economic globalization, it has gone almost without saying that governments in capital-poor countries must prioritize foreign firms' property rights. Accessing foreign capital in the form of FDI is a key means by which economic globalization benefits even the poorest and least developed countries. Multinational corporations' investments provide local employment, access to new technologies, and transfers of knowledge and skills, not to mention tax revenue for governments. In the words of the World Bank, FDI can help "support economic growth, reduce poverty, and improve people's lives."<sup>11</sup> Today, nearly every country in the world has bought into this proposition. In the pursuit of FDI, governments enter into contracts with foreign firms. Governments sign direct contracts via concession and privatization agreements; governments often lock-in tax rates and regulatory standards as terms of investment agreements; and governments enter into international treaties that codify investor rights. These contracts between governments and foreign firms are thought to be effectively self-enforcing, for, if a government were to break its contracts then foreign firms will readily direct their capital elsewhere, *en masse*.

In this view, governments in emerging economies must align their policies and institutions with foreign capital's preferences. Taken to the extreme, the implication is that governments have little to no space to act against the interests of international economic actors.<sup>12</sup> Some have thought that the resulting price of economic globalization is the erosion of the nation state.<sup>13</sup> These most dire expectations for the nation state's future have been tempered by literature on continued policy divergence, even under conditions of

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<sup>11</sup> This is the slogan of the World Bank Group's Multilateral Investment Guarantee Agency. [www.miga.org](http://www.miga.org).

<sup>12</sup> E.g., Cardoso and Faletto 1979; Evans 1979; Rodrik 1997; Soederberg 2001; Rodrik et al. 2004; Van Harten 2005.

<sup>13</sup> E.g., Rodrik 2011, Kobrin 2001, Strange 1996. For a review of similar arguments, see Berger 2000.



globalization. Today, policies diverge across countries on issues directly costly to international economic actors, such as welfare provisions; trade; intellectual property protections; and environmental, labor, and financial regulation.<sup>14</sup> Nevertheless, the argument that economic globalization pressures governments to converge to the particular governing institutions of rule of law and the protection of private property rights has gone virtually unquestioned. The protection of private property rights – and certainly those of foreign firms – has been thought to be the foundation upon which economic integration rests.<sup>15</sup>

We are, however, confronted with an empirical record that emerging economy governments sometimes give in to the temptation of breaking contracts, while in general FDI has remained robust. Governments do not always prioritize the property rights of foreign firms, despite the conventional wisdom that foreign firms exert strong, steady pressure on them to do so. The question arises: under what conditions do the pressures on host governments to maintain foreign firm contract sanctity vary? Why is it that foreign firms sometimes lack the power to compel host governments to adhere to their commitments, even in those countries and industries where the power of foreign firms has gone virtually unquestioned?

## **Argument in brief**

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<sup>14</sup> Swank 2002, Kono 2006, Vogel 1997, Oye and Wellhausen 2009, Singer 2007, Mosley 2011. See also Mosley (2005) for a review of recent research on national governments' "room to move" on domestic policy under conditions of financial globalization.

<sup>15</sup> E.g., Shleifer and Vishny 2002; Acemoglu and Robinson 2006; Rodrik 2007; Alfaro, Kalemli-Ozcan et al. 2008. In such literature written often in response to the early 1990s Washington Consensus, scholars' claims as to necessary conditions for economic development are much limited but nevertheless clear on the continued importance of property rights. Williamson 2000.

I contend that the nation state is embedded in economic globalization at both 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. The political risks faced by firms with the same national origins are linked thanks to a variety of factors, including the bilateral institutions that underlie today's international property rights protections, home and host country foreign relations,<sup>16</sup> and historical ties. Co-national<sup>17</sup> firms also share common business practices, and they face common nationality-tied expectations of their contributions to local development. Because of these similarities, a firm is likely to worry that its own contract sanctity is in danger and take actions costly to the host government when a co-national firm's contract is broken. These costly actions take two main forms. Co-national firms are likely to take advantage of their unique access to home country diplomats and use diplomatic pressure to help shield themselves from breach. Co-national firms are also likely to exit or divert their investments when the shield is pierced and a compatriot faces a broken contract. In contrast, firms of other nationalities have little incentive to risk their defenses, leaving them unlikely to change their investment decisions or behavior toward the host government following that breach. Far from having faded from relevance in a world of economic globalization, nationality shapes foreign firm and diplomatic interests in responding to broken contracts. When the proportion of foreign firms taking costly actions toward the host government shrinks too far, breach and FDI can co-exist.

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<sup>16</sup> "Home" refers to the country from which a foreign investor comes. "Host" refers to the country in which a foreign investor invests.

<sup>17</sup> Co-national refers to firms of the same national origins.

By acknowledging variation in the risks to contract sanctity across different national investor groups, we reach a counterintuitive result at the level of the economy as a whole. Greater nationality diversity among a host country's foreign firms opens space for a host government to break contracts. When a government is host to a greater diversity of national investor groups, any one group's decision to divert FDI has less influence on the host government's current and future access to capital. Additionally, a home country is less likely to have leverage over the treatment of its firms abroad when those firms' continued presence matters less to the host government's capital access. Diplomats are unlikely to expend political capital on a broken contract they have a low likelihood of repairing. Therefore, all else equal, nationality diversity in the investor community increases risks of government breach of contract to FDI in the economy as a whole. When a host economy is more widely integrated with more national groups of foreign firms, emerging economy governments gain power and space to prioritize other interests over foreign firms' property rights.

## **Outline**

In the next chapter, I situate government breach of contract with foreign firms in historical context. In considering trends over time, I discuss how international institutions have attempted to solve the problem of government breach of contract and how scholarly literatures have explained why breach remains persistent. Over the last century, various international institutions have tried and failed to codify foreign firm rights and host government responsibilities with respect to FDI in emerging economies. Bilateral Investment Treaties (BITs) have instead come to codify investment protection, though BITs

has strengthen the international visibility and signaling capability of government breaches of contract. I go on to discuss what explanations scholarly literatures can offer for government breach of contract. While informative, I find the literature's focus on regime type or political institutions insufficient to explain the presence of breach across a variety of kinds of governments. Nor are arguments about the effects of human capital and resource endowments wholly convincing. An older literature is on the "obsolescing bargain," the argument that foreign firms in industries with significant sunk capital are uniquely exposed to an increase in the host government's bargaining power after investments are made.<sup>18</sup> Yet this literature overlooks the many ways firms are captured by location while, at the same time, underestimating the extent to which even foreign firms with high sunk capital costs can credibly threaten incremental exit. However, looking to the level of the firm is crucial to understanding government breach of contract. I set the stage for the dissertation's argument by demonstrating the growth over time in another kind of foreign firm variation: variation by nationality.

In chapter 3, I lay out the dissertation's theory and consider its observable implications. Under what conditions do governments break the contracts they make with foreign firms? I argue that the more varied foreign firms' national origins, the higher the likelihood of government breach of contract. Co-national investors are likely to share risks to contract sanctity, making investors more likely to divert FDI as well as collectively lobby home and host governments following breach with a co-national. In contrast, investors are unlikely to act in ways costly to the host government following breach with investors of other nationalities. The counterintuitive implication is that deeper economic integration

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<sup>18</sup> Vernon 1971.

with a greater variety of investor nationalities undermines, rather than reinforces, foreign firm property rights.

In chapter 4, I present quantitative tests of the effect of FDI nationality diversity on the likelihood of government breach of contract. I first provide quantitative evidence that a key hypothesized causal mechanism is at play. According to the theory, foreign firms should be more likely to divert investments following breach with co-national investors. In contrast, breach of contract with firms of other nationalities should not have a significant impact on co-national FDI flows. I assemble panel data on bilateral FDI flows from 1987 to 2008 to test whether co-nationals differentially divert their investments following breach. The dependent variable is the directed FDI flow from OECD home countries to emerging economy host countries. I operationalize government breach of contract as the incidence of public IIAs brought by foreign firms against host governments. These are public instances in which foreign firms have, as a last resort, committed resources to fight government actions, and host governments have committed to their interpretation of events enough to allow the dispute to go international arbitration rather than settle. If any instances of breach were to send negative signals to investors of all nationalities, it would be these. In fact, as hypothesized, FDI flows are not significantly changed by the instance of an IIA brought by an investor of a different nationality. In contrast, annual FDI flows in the directed dyad decrease by US\$15 – 47 million when co-nationals file IIAs in the previous one to five years. This result provides strong evidence that co-nationals are differentially responsible for capital flight and deterrence following government breach of contract. This sharpens our understanding of the causal micro-foundations of the next set of results, showing that a higher FDI nationality mix is associated with greater likelihood of

government breach of contract. I measure a government's propensity to breach contracts in several ways, including several measures of investor expectations about contractual risks; the pricing of political risk insurance; and the incidence of public IIAs brought by foreign firms against host governments. I operationalize the FDI nationality mix using a Hirschman-Herfindahl Index of the mix of OECD-origin FDI by host country-year. The result that a higher FDI nationality mix is associated with a higher likelihood or incidence of breach is robust across the various specifications of the dependent variable.

The second causal mechanism that differentiates responses to government breach of contract across co-national groups is the fact that co-national actors have unique access to diplomatic and lobbying efforts. These efforts are expected to be most effective in deterring breach and resolving disputes when the FDI nationality mix is low. Chapters 5 and 6 use case studies to trace the role of diplomacy and/or collective action in contract disputes. Cases are supported by over 130 interviews conducted in Ukraine, Moldova, and Romania, with local heads of foreign firms, government officials, foreign investor associations, legal professionals, and multilateral organizations between 2009 and 2012.<sup>19</sup> Ukraine, Moldova, and Romania are useful settings in which to test the theory. These countries do not have the market size or natural resource endowment that may give some host governments special leverage over foreign firms. They vary in levels of economic development, providing an opportunity to demonstrate that breach of contract is not only a phenomenon in poor (or rich) countries. Their shared geography and history help to

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<sup>19</sup> Supplementary interviews were 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 the Appendix for more information on the interview strategy.

constrain the set of foreign direct investors either currently investing or interested in investing.

In chapter 5, I leverage over-time variation in the nationality diversity of the investor community in Ukraine to explain the presence and effectiveness of foreign firm and diplomatic collective action in deterring breach. In chapter 6, I compare the experience of foreign firms in Moldova and Romania, two emerging economies at very different levels of development and subject to different institutional constraints. I argue that the low FDI nationality mix in Moldova and the high FDI nationality mix in Romania account for the very different levels of co-national action in the two countries, contributing to the effective absence of breach in Moldova and high levels of breach in Romania, even after it joined the European Union.

In the final chapter, I consider what the dissertation's theory and evidence mean for our expectations about the link between deeper economic integration and rule of law. Explaining 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. Deeper global integration, via exposure to a greater diversity of foreign firms, need not engender better government commitments to contract sanctity and rule of law. As a result, the malleability of contracts between foreign firms and host governments depends on the set of foreign firms present in the host country at any one time. Diversity can be a liability to foreign firms. Yet firms have nevertheless found ways to deal with this uncertainty, as evinced by the long-term secular increase in FDI to emerging economies.

In short, 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.

Instead, case studies suggest that more consistent sources of contract sanctity may lie elsewhere. For example, steadier rather than episodic diplomatic involvement in investors' contract sanctity may be effective, as may investments in which owners of many nationalities hold stakes. Even so, it is far from certain that blanket increases in contract sanctity are necessary for host governments to achieve their many domestic goals – or for multinational corporations to earn profits. In fact, development policy prescriptions that are based on protecting property rights above all else may hold governments back from breaching for the benefit of the domestic polity when foreign capital would, on the whole, remain indifferent.



## Chapter 2: A History of Government Breach of Contract

Before presenting the argument about the effect investor nationality and the diversity of the investor community have on government breach of contract, this chapter traces the evolution of government breach of contract over the twentieth century and particularly in the post-WWII era. Observers often characterize breach as nationalization, but emerging economy governments have in fact developed a repertoire of ways to unlawfully appropriate benefits from foreign direct investment (FDI). Governments do this not only through the transfer of ownership from foreign firm to host government, but also by changing the particular regulatory, tax, and other commitments made to foreign firms. In this way, host governments have tried to walk a fine line between access to foreign capital and the sometimes breach of commitments to foreign capital in favor of domestic priorities.

Conventional wisdom would posit that governments can no longer walk this line since the liberalization of capital flows starting in the 1980s. Free-flowing capital has made the relatively long-term employment, technological, and developmental impacts of FDI both more available and more important to capital-scarce emerging economies. The thought has been that access to capital requires unchanging respect of foreign firm property rights and, certainly, the government's respect for contracts foreign firms make with the government itself. In the absence of this respect, mobile capital would go elsewhere. Puzzlingly, public breach of contract in most if not all emerging economies at different times has not had such stark deterrent effects: FDI into emerging economies

continues to trend upward alongside the incidence of publicly recorded government violations of foreign firm property rights.

Multilateral legal efforts over the second half of the twentieth century were unsuccessful in binding governments to respect foreign firm property rights (or, alternatively, binding foreign firms to allow latitude to host governments). Bilateral treaties, which have come to substitute for failed multilateral action, legally protect foreign firm rights yet publicize ongoing instances of breach of contract – underscoring the puzzle of continued FDI even when information about breach is readily available.

Scholars have turned to characteristics of a country's political regime or to characteristics of the assets in which foreign firms invest to explain the incidence of government breach of contract. Foreign firms themselves have been left as a black box. In contrast, I identify and trace one little explored characteristic of FDI over the twentieth century: the increasing diversity of multinational corporations' national origins. Multinationals once came from the richest countries and, often, former colonial powers. But in the last decades, firms from across Europe, North America, and Japan have become multinationals; firms from middle-income and even less developed countries have also begun investing abroad. Since the 1990s, in particular, two trends have converged: host governments have become more reliant on long-term, foreign-owned FDI, and foreign firms from a multitude of home countries have begun providing that capital. This sets the stage for the unexpected result that deeper integration into the global economy, as measured by the increasing national diversity of a host government's foreign firms, increases the likelihood of government breach of contract.

In this chapter, I first define government breach of contract along a spectrum from full nationalization to unlawful but ownership-preserving incidents of “creeping expropriation.”<sup>20</sup> I review the incidence of government breach of contract, with special attention to the post-WWII period when breach was a means for host governments to reassert control in an era of economic nationalism and post-colonial rebuilding. I go on to describe the changing character of breach alongside the liberalization of international capital flows. Failed multilateral legal efforts around foreign firm (and host government) rights capture the fundamental conflict between sovereignty and property that multinational corporations have butted up against again and again. I review scholarly explanations for why foreign firms sometimes lose out in this conflict, which point to regime type and the mobility of assets as key determinants of breach. But with regimes of all types breaking contracts, in a growing multitude of ways, in a multitude of industries, these variables cannot provide an adequate explanation. Finally, I introduce the trend of growing national diversity in the origins of multinational corporations to prime the dissertation’s examination of the role nationality plays in mitigating or exacerbating risks of breach.

## **Background**

Private, voluntary transactions have long been characterized as the backbone of a market economy. For such an economy to work, private property rights must be secured

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<sup>20</sup> 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 indeed unlawful. See the Section *BITs and breach of contract today* for more discussion of what contemporary unlawful government breach looks like.

such that voluntary transactions can take place, and the state has been the actor tasked with maintaining this security. One way a state can fail to secure property rights is if it does not provide adequate institutions to define private property rights and govern disputes between private parties, though forces other than the state's intentional actions can weaken such institutions. A failure directly attributable to the state occurs when the state does not adequately restrain itself from infringing on private property rights. Carving out state property and private property, and respecting the difference, is part and parcel of what we know as state respect for the rule of law. Rule of law does not require the state to give up the ability to act counter to private property: every state reserves the right to interfere with private property in some instances, for example, when invoking eminent domain. Rather, the state must exercise its sovereignty within the constraints of predetermined rules. This compact over property protections is at the core of the social contract between citizens and their government.

Foreign firms entering a host economy are not part of the social contract between the state and its citizens. In other words, the state is not obliged to protect foreigners' property rights in order to continue to legitimately exist. Foreign firms thus lack the direct connection domestic citizens and firms have between their preferences and the government's ability to remain in power. Nevertheless, when host states allow foreign firms to do business within their territory, they make an analogous commitment to refrain from unlawful interference with those foreign firms' property. This commitment is not the intimate social contract between a sovereign and its own citizenry. Rather, this commitment is contractual in the arms-length, impersonal, formal, and contingent sense of

the word.<sup>21</sup> The state commits to non-interference with foreign-owned property in order to gain the economic advantage of accessing foreign capital. Foreign capital can support economic development especially when domestic capital is scarce, through local tax dollars, job creation, and more. If host governments overstep and arbitrarily devalue foreign-owned property, the expectation is that foreign capital will no longer be around to provide these sorts of benefits. Foreign capital will flee and new capital will be reluctant if not unwilling to enter. So long as the host government sees advantages to hosting foreign capital, the property rights contract and its underlying threats have teeth.

Some forms of foreign capital are particularly good at baring their teeth when host governments threaten to violate their property rights. Portfolio investors do not take on management roles in domestic business, earning them the moniker of “hot money” that can quickly exit and move elsewhere. These investors therefore have an advantage of speed in responding to the first whiff of a threat to their property, underpinning the sanctity of portfolio investors’ property rights with the host government. Individuals abroad who send remittances back to their families in their country of origin make up large and influential flows of international capital, especially in some of the world’s most impoverished countries. These individuals and their families living in host countries can wield domestic political power with the help of remitted money, should the government unlawfully interfere.<sup>22</sup> Actors in this capital flow, too, gain leverage over an emerging economy government.

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<sup>21</sup> Ahlquist and Prakash (2008) find a positive spillover effect of foreign firms’ use of formal contracts in managing their private transactions, documenting a positive correlation between FDI and local confidence in commercial contract enforcement.

<sup>22</sup> Singer 2010, Leblang 2010, Ahmed 2012.

Those who lend directly to governments constitute another group that has well-recognized tools available to shore up its contract sanctity. Mosley finds that sovereign bondholders dedicate time and resources to gather information about macroeconomic trends in emerging economies as well as about social policy, infrastructure spending, and the presence of ideologically charged policies contrary to bondholder interests.<sup>23</sup> When this information suggests increased risks of sovereign default, bondholders have the International Monetary Fund (IMF) on which to call, an institution tasked with promoting international monetary cooperation and stability. Additionally, collective action clauses (CACs) have become standard components of sovereign bonds since the early 2000s; getting bondholders to sign on to a CAC requires governments to commit to attractive terms in case of default.<sup>24</sup> Further, since the advent of sovereign bond markets in the nineteenth century, private bondholders have home governments have at times supported bondholders when default looms.<sup>25</sup> Sovereign bondholders thus benefit from international institutions, market practices, and diplomatic support that aim to keep contracts as whole as possible, ensuring at worst an orderly and legalized restructuring.

### **Foreign direct investment (FDI)**

In contrast to investors in other international capital flows, firms undertaking foreign direct investment (FDI) have had a different sort of ace in their pocket when it

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<sup>23</sup> Mosley 2003. In contrast, Tomz (2007) emphasizes the presence or absence of past default as the key input into bondholders' risk perceptions, implying that bondholders need incur few search costs to be well-informed on default risks.

<sup>24</sup> CACs also allow governments to prevent holdout bondholders from demanding more once other bondholders have agreed to debt relief. CACs became market practice after Mexico in 2003 made a major issue of bonds with CACs in the US market. Haessler 2010.

<sup>25</sup> For example, see Feis 1964, Platt 1977. Tomz, however, clarifies that that this support has been diplomatic rather than via "gunboats" or military action. Tomz 2007.

comes to ensuring protection of their property rights: host governments want the development contributions typical of FDI. Direct foreign investment in, and foreign ownership of, assets in emerging economies has become a much sought-after means of promoting economic development. 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.” Foreign direct investors thus take management positions in their investments. They typically have long time horizons and 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.<sup>26</sup> Foreign firms with any of these motivations can make positive contributions to local development. For example, foreign 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, and foreign 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.<sup>27</sup> Not to be forgotten, foreign firms are key sources of tax revenue as they are as often among the richest players in an emerging economy.

Moreover, by establishing long-term operations abroad, foreign firms provide capital and also transmit management know-how and technical knowledge alongside. Some

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<sup>26</sup> Dunning 1980.

<sup>27</sup> E.g., Farrell et al 2004. But see Moran 2005.

transmission mechanisms are 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.<sup>28</sup> These relationships can facilitate learning in the host economy by introducing both codified and tacit knowledge held by multinationals. 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 their product or engaging in downstream activities, and to other firms in the same industry.<sup>29</sup>

Scholars of dependent development see competition for FDI as problematic, prolonging emerging economies' dependence on other, richer countries for their livelihoods. Others see convergence on FDI as a capital source as a useful and efficient means for foreign firms to take advantage of opportunities abroad and for scarce capital to be better distributed to capital-poor locations.<sup>30</sup> The spread of foreign investment promotion agencies (IPAs) and concerted investment attraction activities to nearly every country in the world goes to show that host governments today find the potential benefits of FDI good enough to fight for. Because FDI provides benefits for host economies, host governments have incentives to both attract foreign firms and keep their property rights secure. Both scholars and policymakers have made this point. Eaton et al argue that the threat of government expropriation "can significantly distort the international allocation of

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<sup>28</sup> Blomstrom and Kokko 1997.

<sup>29</sup> Evidence of productivity spillovers is mixed (see Moran 2005).

<sup>30</sup> E.g., Obstfeld 1998, Dunning 1980, Huang 2003.



capital even if the act of expropriation is relatively rare.”<sup>31</sup> Huang argues that China treats foreign firms with kid gloves because the country’s own political economy would be dysfunctional in their absence.<sup>32</sup> 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.<sup>33</sup> Even President Atatürk of Turkey expressed this sentiment 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.”<sup>34</sup>

Firms, for their part, have been eager to take advantage of opportunities overseas. European chartered trading companies, like the English East India Company, engaged in what was essentially FDI as far back as the sixteenth century.<sup>35</sup> In the next centuries, colonial powers made “foreign” investments as they exploited resources in their colonies abroad. By the mid to late nineteenth century, technological improvements made robust international commerce and international investment feasible. Railroads spread over continents, improvements in shipbuilding allowed for longer voyages, and advances in telegraphy improved communication between firms and overseas affiliates as never before. These advances came to a head with the dawn of what is known as the First Globalization, beginning around 1871 and lasting until the First World War broke out in 1914. In this

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<sup>31</sup> Eaton et al 1984: 16.

<sup>32</sup> Huang 2003.

<sup>33</sup> Kerner 2009: 78.

<sup>34</sup> Robinson 1963: 106. Quoted in Lipson 1985: 72.

<sup>35</sup> For a discussion of FDI’s historical permutations, see Litvin 2003.

period, the Gold Standard facilitated robust international flows of portfolio capital. FDI, too, was higher than before. In 1914, one-third of total world foreign investment is estimated to have been FDI, amounting to US\$14600 million.<sup>36</sup>

In the era of globalization that began in the decades following WWII, governments have again liberalized international capital flows. In the 1970s, emerging economy governments used sovereign debt to finance domestic investments, but by the 1980s new loans were going to pay for old loans. This became unsustainable and some twenty countries, mostly in Latin America, defaulted on their debt and rocked the world of sovereign lending. Financing domestic development through sovereign borrowing became an unpopular and expensive development strategy. Since then, emerging economy governments have come to see FDI as a key means to reap benefits from economic integration and have eased regulation on cross-border investment accordingly. 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 revenues via foreign affiliates. By the 2000s, FDI accounted for some two-thirds of world foreign investment flows. In 2010, the accumulated stock of FDI in the world surpassed US\$19 trillion. This value is nearly four times the US\$5 trillion in world FDI in 2000 and some 27 times the US\$700 million in 1980. Today, some 82,000 multinational corporations, with over 800,000 affiliates, undertake FDI. In 2010, the accumulated FDI stock in emerging economies reached US\$6.6 trillion, or 35 percent of world FDI stock.<sup>37</sup>

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<sup>36</sup> Dunning 1993.

<sup>37</sup> United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on

However, the complexity and “stickiness” of FDI that, indeed, accounts for many of its developmental benefits, makes it vulnerable to government opportunism. Foreign direct investors build new factories in host economies, enter into joint ventures with domestic businesses, buy privatized assets, and otherwise own office space in host countries. More than investors in other capital flows, foreign direct investors operating in the host government’s jurisdiction rely on the basic contract that the state will not interfere with money-as-property, intellectual property, or tangible physical property. They also rely on a stack of state commitments made on top of that basic compact, in more or less explicit contracts over regulation, tax laws, profit sharing with the government, and more. Because FDI can be hard to move, foreign direct investors have all the more reason to divert their investments, or begin the process of exit, at the first sign of threats to their own contracts. The conventional wisdom, which this dissertation goes to disprove, holds that a host government’s violation of its contracts with any foreign firm constitutes such a threat.

### **Contracts and breach of contract**

Host governments contract directly with foreign firms in a variety of ways: governments are the counterparty on privatizations; they license foreign firms to run infrastructure and natural resource concessions; they enter into joint ventures with foreign firms; they commit to regulatory standards in the terms of investment agreements. In general, governments make a variety of more or less formal commitments to ensure foreign firms’ ability to operate by virtue of allowing foreign firms to enter the domestic economy. What this dissertation terms “government breach of contract” covers adverse government

actions toward explicit contracts that foreign direct investors enter into with a host government, as well as government violations of its fundamental commitment to protect foreign-owned property.<sup>38</sup> The underlying set of relevant government actions ranges from the full transfer of ownership from foreign firm to state, to breach that unlawfully reduces foreign firms' ability to be profitable though ownership status is left unchanged.<sup>39</sup>

Nationalization, or "the forced divestment of the equity ownership of a foreign direct investor,"<sup>40</sup> is the government breach of contract most widely recognized and dealt with by the academic literature. Nationalization is the full or near-full expropriation of foreign assets, moving ownership from a foreign private entity to host government control. 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. For example, the host government can induce, via threat, foreign firms to sell their property to the government or to domestic citizens in a coerced sale.<sup>41</sup> All of these expropriations involve a change in ownership, making them nationalizations in different degrees, even if some compensation is paid. Figure 1 shows the countries around the world that have nationalized foreign-owned property from the First World War to 1990.

Nationalization is not the only way governments can violate foreign firms' contract sanctity. Host governments also practice "creeping expropriation" when they breach foreign firms' contracts without necessarily transferring ownership. Creeping

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<sup>38</sup> I speak of "contracts," that states enter into in order to further their interests, rather than "covenants," which manifest normative commitments. Abbott and Snidal 2003.

<sup>39</sup> Kobrin 1980, 1984.

<sup>40</sup> Kobrin 1980.

<sup>41</sup> Tomz and Wright 2008.

expropriation can take place through discriminatory policy changes, forced contract renegotiations, and other undue interference with foreign firms' operations.<sup>42</sup> In other words, the host government acquires value from (or takes value away from) a foreign-owned investment rather than taking an equity stake. For example, governments can break often written contracts regarding the repatriation of profits by forcing conversions to local currency or blocking outflows. Regulatory taking is the name for one kind of creeping expropriation, which occurs when the government breaks contractual commitments to foreign firms via changes to regulatory and tax structures. These changes can violate explicit contracts if governments have committed to certain tax rates or regulatory standards for a period of time in the terms of the investment agreement, something that is increasingly standard practice in thick written contracts between a foreign firm and the host government.<sup>43</sup> This dissertation's use of "breach of contract" and "political risk" excludes instances of political violence, civil unrest, terrorism, and war, all of which pose real risks for foreign firms but are not clear instances of a host government's intentional choice to target and violate foreign firms' property rights.

The puzzle here is why governments sometimes actively choose breach with foreign firms over contract sanctity. Other analysts focus on "macropolitical risks," like macroeconomic instability, as important government-derived risks facing investors in emerging economies.<sup>44</sup> Indeed, government decision-making around monetary and fiscal policy may affect the value of investments in an economy as a whole. However, this dissertation does not focus on changes in broad government policies *per se*. The puzzle

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<sup>42</sup> Kobrin 1982, Lipson 1985, Jakobsen 2006.

<sup>43</sup> See chapter 6 for examples.

<sup>44</sup> Prioritizing macroeconomic political risk is central to the International Monetary Fund's (IMF) mandate. Interview, IMF official, Eastern Europe. See also Wilkin 2000.

considered here arises 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, or of breaking direct promises to particular foreign firms. In these situations, government policy changes are not merely "unfriendly" to owners of capital but rather violate particular commitments the state has made to protect foreign firms' rights to operate. Again, by focusing on the clearest instances of host governments breaching commitments to, or contracts with, foreign firms, this dissertation interrogates the most puzzling aspect of breach and contract sanctity: ongoing FDI, although host governments sometimes choose to breach contracts with foreign firms.

An increasingly robust political risk insurance (PRI) industry has grown up to provide foreign firms one means of managing the risk of breach of contract.<sup>45</sup> 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.<sup>46</sup> Subsidized PRI comes from national organizations, such as at 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 forged 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."<sup>47</sup> The World Bank Group chartered a PRI affiliate, the Multilateral Investment Guarantee Agency (MIGA), in 1988. Like other providers, MIGA sells coverage against

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<sup>45</sup> As is true of insurance in general, payouts from political risk insurance rarely make a foreign firm whole.

<sup>46</sup> Bolt, Tom. "Market Bulletin: Lloyd's Risk Code Scheme," Ref. Y4399, *Lloyd's* (25 May 2010).

<sup>47</sup> OPIC website. <http://www.opic.gov/insurance/coverage-types/expropriation>.

government actions “that may reduce or eliminate ownership of, control over, or rights to the insured investment.”<sup>48</sup> This set of broad definitions of government breach of contract underscores the fact that breach is about more than nationalization and the transfer of ownership.

## History

For as long as firms have done business overseas, they have had to interact with sovereign governments on unequal footing. Host governments have taken advantage of their sovereignty in times of war when seizing the local assets of investors coming from enemy states on the grounds of national security. In fact, one reason the British did not support the Confederacy in the American Civil War (1861-1865) was for fear of the sanctity of British investments in the North.<sup>49</sup> Absent the extenuating circumstances of war, do foreign firms hold power over host governments in this unequal relationship? While many commentators may answer yes, instances of government breach of contract have occurred and continue to occur. In the twentieth century, what many see as the heyday of nationalization and expropriation took place in the 1960s and 1970s. While some equated the dying out of mass nationalization with the end of expropriation,<sup>50</sup> creeping expropriation and other forms of government breach of contract continue. These more recent incidents of government breach of contract throw the puzzle of simultaneous FDI growth and breach in emerging economies into stark relief. While many earlier

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<sup>48</sup> MIGA website. <http://www.miga.org/investmentguarantees/index.cfm?stid=1797#toc2>.

<sup>49</sup> Jones 1992.

<sup>50</sup> E.g., Minor 1994.

nationalizations occurred when governments rejected the idea of FDI, today's breaches of contract take place in countries that actively expend resources on attracting FDI.

The first major nationalizations of the twentieth century came in the Russian Revolution of 1917. Soviet nationalization stood out for its completeness and the total absence of compensation to foreign firms. Assets nationalized from American investors alone were valued at the time at US\$175 million.<sup>51</sup> An analogous total nationalization came after the 1959 communist revolution in Cuba. A contemporary analyst valued the assets of the 137 American firms this affected at US\$1400 million.<sup>52</sup> In both the Soviet Union and Cuba, the basic compact between foreign firms and the host government ceased to exist: the host government no longer desired foreign investment and thus had no reason to maintain its credible commitment to foreign firm property rights. Lipson argues that the term "nationalization," which emerged in after World War I, reveals that expropriation is "rooted in broad conceptions of the social character of property rights."<sup>53</sup> In these cases, communist ideology had it that property rights belonged to the nation, and not to foreign interests; mass expropriation logically followed.

In the interwar period, breach of contract with foreign firms in non-communist regimes was more selective. The difference was that governments desired long-term foreign investment in general, even if foreign ownership in certain circumstances was revoked. For example, under Mustafa Atatürk's presidency, Turkey at first expressly retained its commitment to foreign investment as a means of development. However, after nearly a decade in power, President Atatürk authorized in 1932-1933 the takeover of key

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<sup>51</sup> Root 1968.

<sup>52</sup> Ibid.

<sup>53</sup> Lipson 1985: 120.



parts of Turkey's infrastructure, namely foreign-owned public utilities, coalmines, and railroads. Though the final settlement was spurred by Turkey's unilateral change of heart about foreign ownership, Turkey paid compensation for these assets that seems to have satisfied foreign firms.<sup>54</sup> In Mexico in 1938, the government took over US-owned ranches as well as some US oil interests, valued together at US\$120 million.<sup>55</sup> In this case, the American ranchers' claims were settled in the 1940s. Such a breach targeted at US interests is distinct from the ideologically charged, comprehensive Soviet and Cuban actions.

Figure 2 uses two different measures to summarize how many countries broke contracts with foreign firms annually from 1960 to 1990. The first is nationalization, which peaked in the 1970s as up to 30 countries nationalized at least one foreign-owned firm per year. For the period 1956 to 1972, emerging economy governments seized foreign-owned assets worth US\$10 billion, which amounted to nearly 25 percent of the total stock of FDI in the world at the end of 1972.<sup>56</sup> It was not the same cohort of countries nationalizing property each year. For the period 1960 to 1976, Jodice counts 76 different states expropriating 1535 firms, from a total of 22 home countries.<sup>57</sup> The second measure in Figure 2 is a count of states sued by foreign investors in public, international lawsuits known as international investment arbitrations (IIAs). While IIAs were relatively uncommon in this period, they would grow to prominence in the 1990s and 2000s as discussed below.

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<sup>54</sup> Berrios et al 2011.

<sup>55</sup> Root 1968.

<sup>56</sup> Williams 1975. Jodice calculated that approximately 12 percent of FDI flows in 1967 were nationalized in the following nine years. Jodice 1980: 185.

<sup>57</sup> Jodice 1980.

Nationalization in the 1960s and 1970s was both broad and deep in many host countries. Kennedy defines “mass expropriators” as governments that nationalized foreign firms in banking, natural resources, services, and manufacturing.<sup>58</sup> In the period 1960 to 1985, 28 political regimes in the developing world fit that description (see Table 1). These governments are mostly in sub-Saharan Africa and North Africa and the Middle East, although the Chilean Allende regime’s expropriation of American copper interests, among other takings, was particularly infamous in the United States.<sup>59</sup> The regimes in Table 1 account for 63 percent of expropriatory government actions in the period, counted by the incidence of nationalization per country-year.<sup>60</sup>

The broad and varied instances of breach under these regimes demonstrate the political and economic roles government breach of contract came to serve. In this period, a rise in economic nationalism and an ideology of state intervention in the economy shaped domestic narratives around expropriation.<sup>61</sup> Governments choosing nationalization saw foreign investment as “a symbol of Western industrialization and Western colonialism” to be rejected.<sup>62</sup> In these countries, the basic belief that foreign investment is an important part of domestic economic development was weak. Expropriation became a means to reject “the general context as well as the specific enterprise.”<sup>63</sup> Nevertheless, unlike in the case of the Soviet Union or Cuba, regimes’ nationalist or ideological rejection of the presence of FDI was not absolute.

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<sup>58</sup> Kennedy 1992.

<sup>59</sup> Ingram 1974, Moran 1974.

<sup>60</sup> That is, 374 expropriatory acts of 598. An act is counted as the nationalization of at least one firm in a country-year. Kennedy 1992.

<sup>61</sup> Lipson 1985: 146.

<sup>62</sup> Kobrin 1984: 339-340. Quoted in Kennedy 1992: 74.

<sup>63</sup> Kennedy 1992.

Expropriations in Africa from 1960 to 1977 are representative of the scope of government breach of contract in this era. African regimes expropriated large, extractive enterprises owned by multinational corporations; local subsidiaries of multinationals, predominately in banking, insurance, and petroleum production and distribution; and small and medium enterprises owned by resident aliens from former colonial powers as well as migrant populations (including Indians, Pakistanis, Sri Lankans, Lebanese, and Greeks).<sup>64</sup> A number of African regimes, like the formerly French colony Algeria and the formerly British colony Tanzania, were avowedly Socialist and undertook expropriations across the economy (see again Table 1). Revolution in the wake of colonialism provided a ready foundation for mass expropriation of foreign-owned assets.<sup>65</sup> Yet even these countries did not wholly reject the compact that foreign investment is useful to domestic development; Algeria and Tanzania continued to work to attract FDI in “approved” projects.<sup>66</sup> In efforts to walk the line between domestic incentives to expropriate and the desire for foreign capital, African countries began to exploit more options along the continuum from contract sanctity to nationalization. Instead of only forcing changes of ownership from foreign to domestic, governments forced renegotiation of concession agreements, unduly intervened in foreign operations, requisitioned foreign profits, and used “indigenization” policies to limit foreign participation in some sectors, forcing foreign investors to partially divest.<sup>67</sup>

International oil and gas firms have often made headlines in their struggles over property rights protections with host governments. Analysts have counted between 99 and

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<sup>64</sup> Akinsanya 1981.

<sup>65</sup> A similar revolutionary dynamic lay behind Iran’s mass expropriations in 1979.

<sup>66</sup> Akinsanya 1981: 778.

<sup>67</sup> Akinsanya 1981.

120 government breaches of contract in the oil and gas sector from 1960 to 2008, including nationalizations, the forced sale of foreign assets, and forced contract renegotiations.<sup>68</sup> However, the broader phenomenon of government breach of contract is not limited to this sector. Table 2 summarizes the sectoral distribution of 508 expropriatory actions from 1960 to 1976.<sup>69</sup> While petroleum expropriations accounted for 18.7 percent of adverse government actions in this period, manufacturing alone accounts for 27.2 percent of expropriations. Banking and insurance as well as mining and smelting each account for over 10 percent of recorded events. Relative to the size of these industries' share of total FDI stock, petroleum as well as manufacturing and trade are "under-expropriated." Table 3 reproduces data on the expropriation of 170 US firms from 1946 to 1973. In the pre-1960 period, 50 expropriations took place in the extractive industries, including both oil and gas and mining. While the number of firms expropriated in extractive industries continued to be high over the next decades, more and more financial and manufacturing firms were also targeted. Utilities, while originally on par with extractive industries, declined as a target for expropriation. As we will see later, oil and gas has remained a politically risky industry in recent decades, but government breach of contract continues to be distributed across industries.

Table 3 also includes information on what kinds of other firms shared these US firms' fate. On occasion, the nationalization of foreign firms took place alongside domestic firms when an entire industry was transferred to the host government's hands. More often, though, foreign firms were particular targets, whether within or outside the context of a particular industry. The targeting of foreign firms during the first half of the twentieth

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<sup>68</sup> Data from Kobrin 1980, 1984; Hajzler 2012; Guriev et al 2009.

<sup>69</sup> Jodice 1980.

century and certainly the 1960s and 1970s gave rise to a series of attempts by both capital-exporting and capital-importing countries to deal with breach, though the first set favored stopping breach and the second only its regulation.

## **Legal attempts to forestall breach**

In the First Globalization (1870-1914), customary international law held sway over the status of investments made abroad. Under international norms, states were required to make prompt, full compensation, in convertible currency, for takeovers of foreign property. Such takeovers were to be limited to “exceptional public purposes.”<sup>70</sup> Carlos Calvo, an Argentine jurist, developed the “Calvo Clause” in the late 1890s, which became the strongest challenge to customary law. Calvo argued that foreigners should be treated like local citizens and as participants in local commerce on an equal basis. The implication was that no state should intervene, through diplomats or any other forms of pressure, to enforce its citizens’ private claims in a foreign country.<sup>71</sup> The Calvo Clause appealed to many countries hosting FDI, both during and after the first globalization. Mexico famously defended its 1938 expropriation of US-owned property on this basis. In a note to the Mexican Minister of Foreign Affairs, US Secretary of State Cordell Hull issued the “Hull Doctrine,” re-articulating the terms of customary law in what is known as the Hull Doctrine: “no government is entitled to expropriate private property, for whatever purpose, without provision for prompt, adequate, and effective payment therefore.”<sup>72</sup> Compensation has long been an important point for the United States. In 1962, the US Congress tried to

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<sup>70</sup> Lipson 1985: 73.

<sup>71</sup> Lipson 1985: 282, note 51; 80. Ginsburg (2005) argues that the Calvo Clause allowed recourse to home country resources once local remedies are exhausted.

<sup>72</sup> Schachter 1984.

reinforce the Hull Doctrine with the Hickenlooper Amendment, which required the president to cut off assistance to countries that expropriate US firms without prompt, adequate, and effective compensation, though US firms came to reject this remedy as so antagonistic as to be counterproductive.<sup>73</sup> This later US effort reflects the broader change in international norms and international law over the twentieth century: no longer is the home government's diplomatic involvement in its investors' property disputes abroad seen as unlawful.

Since 1907, international organizations have come together at least twenty times to specify what exactly is lawful treatment of foreign firms: what are foreign firms' rights, and what are the rights retained by sovereign governments that host foreign investment? Table 4 summarizes these twenty attempts. In early efforts, capital-exporting and capital-importing countries were not able to agree on the obligations either of states or firms. In the 1960s and 1970s, the United Nations Conference on Trade and Development (UNCTAD), the OECD, and the International Labor Organization were able to adopt only voluntary standards for both host governments and multinational firms. These include recommendations that firms follow local laws, refrain from collusion, offer good working conditions, and disclose operational data to host governments. A series of United Nations General Assembly Resolutions reserved to host governments special rights over natural resources and special rights over the treatment of foreign firms in related industries. In one of these Resolutions, the General Assembly declared that nationalization is "an expression

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<sup>73</sup> The Sugar Act Amendment, passed in 1971, gave the President authority to reduce or eliminate a country's sugar quota when there was evidence of discrimination against a US firm. In 1972, the Gonzalez Amendment required US representatives to the International Development Bank and the World Bank to vote against loans to nations that expropriated US property without adequate compensation. It was in fact employed only twice, in Sri Lanka and Indonesia, before being phased out. See Lipson 1985.

of the full permanent sovereignty of the State.”<sup>74</sup> Yet again, these Resolutions were far from identifying any consensus among capital-exporters and capital-importers, and efforts to codify their sentiments into international law failed.

In fact, international organizations have regularly deserted attempts to make the rights of either host governments or firms enforceable under international law. For example, UNCTAD attempted in 1977 to negotiate an International Code of Conduct on the Transfer of Technology, which recognized a sovereign right of states to facilitate and regulate the transfer of technology from foreign firms to domestic actors. Capital-exporting countries balked at the legally binding code and negotiations were abandoned in 1985. More recently, the OECD began negotiations on a Multilateral Agreement on Investment (MAI) in 1995. OECD countries intended the MAI to be a legally binding treaty to ensure foreign firms have both most favored nation treatment and national treatment (that is, treatment equivalent to that of domestic firms) both pre- and post-investment. Emerging market countries balked at this, as did anti-globalization activists in France, the United States, and other OECD countries.<sup>75</sup> Negotiations were abandoned in 1998.

The World Trade Organization (WTO) provides foreign direct investors multilateral protection of their property rights only at the fringes. The General Agreement on Trade in Services (GATS), negotiated from 1986 to 1993, precludes WTO members from using investment measures that affect trade in services.<sup>76</sup> The Agreement on Trade-Related Investment Measures (TRIMs), negotiated from 1986 to 1995, limits investment measures related to trade in goods. Aside from these limitations, WTO member governments are

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<sup>74</sup> UN General Assembly, “Declaration and Action Programme on the Establishment of a New International Economic Order,” 6 May 1974.

<sup>75</sup> For an analysis of French protest, see Ancelovici 2002.

<sup>76</sup> “Investment measures” are government policies toward FDI or multinational corporations.

allowed to set policies specific to foreign firms.<sup>77</sup> Moreover, disputes arising under GATS and TRIMS are, like all disputes in the WTO, resolved only at the inter-state level. This means that multinational corporations with a grievance must lobby their home governments to file a case with the WTO. Scholars have examined the intense politics behind bringing WTO cases; suffice it to say, foreign firms will more often than not find little to no direct or speedy reprieve for broken contracts under limited WTO protections.<sup>78</sup> Even if the home government agrees to file a case on its firm's behalf, the host government need not change its policy toward that particular, damaged firm. This is because WTO remedies do not require the host country to reverse its actions but rather operate by allowing the home government to retaliate via trade measures. From the point of view of the multinational corporation, therefore, protections under GATS and TRIMS do not incontrovertibly deter breach of contract by WTO member governments. Recognizing the limited nature of its protections for firms engaged in direct investment, the WTO opened a Working Group on Trade and Investment in 1996. This Group intends to explore a Possible Multilateral Framework on Investment in the style of the failed OECD MAI. However, the Group has no negotiating authority, and further exploration of the issue was planned for the WTO trade negotiation round after the Doha Development Round. Progress has thus been delayed as the Doha Round, which commenced in 2001, remains stalled in 2012.

### **One attempt: UN Code of Conduct on Transnational Corporations**

A special United Nations Commission on Transnational Corporations, formed by The UN Economic and Social Council, attempted in 1977 to negotiate a legally binding Code of

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<sup>77</sup> Developing countries that are WTO members have five or seven year windows to delay the elimination of TRIMs.

<sup>78</sup> See, for example, Chaudoin 2012.



Conduct on Transnational Corporations. As they were among the main capital-exporting countries at the time, the US, UK, Germany, and Japan were made permanent members of the Commission. The other 44 Commission members were distributed over world regions. Negotiations on the Code remained active until 1983 but never reached a consensus; a 1992 intergovernmental group finally discarded the Code and recommended other strategies to strengthen investor-host country relationships – a recommendation that Bilateral Investment Treaties (BITs) were beginning to fulfill (see below).

The draft Code provides a good example of the struggle between capital-exporting and capital-importing governments over the right to private property and the maintenance of sovereignty. The steep rise in expropriation events in the 1970s spurred this particular multilateral effort (see again Figure 2). As might be expected, the Commission suffered from conflicting purposes from the beginning. In reality, the Commission's official highest priority was to set a Code to include standards for the treatment of multinational corporations. These standards were to codify host government rights and responsibilities with regard to nationalization and compensation, dispute settlement procedures, fair and equitable treatment, and transparency and jurisdiction issues.<sup>79</sup> However, capital-importers saw the Commission as providing a forum where, first and foremost, action could be taken to strengthen a host country's power over multinational corporations. Put differently, capital-importers expected the Commission to address what dependency theorists see as the fundamentally asymmetric ability of multinational corporations to constrain governments' freedom of action.

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<sup>79</sup> Correa and Kumar 2004: 32-33.

The draft Code required commitments from multinational corporations to which capital-exporting countries would not agree.<sup>80</sup> In particular, the Code read that multinational firms “should carry on their activities in conformity with the development policies...set out by the Governments of the countries in which they operate.”<sup>81</sup> Underlying this provision is the assumption that host governments can rightfully set development policies that discriminate against FDI in general or certain foreign firms in particular, which is in conflict with the notion that foreign firms have a right to most favored nation treatment and national treatment. Arguably, such autonomy for host governments would even conflict with historical customary international law that presumed a very narrow scope for legitimate government interference with foreign-owned property. As one example of such development policies, the Code stated that firms should honor government requests to stop or limit repatriation of funds “with a view to contributing to the alleviation of pressing problems of balance of payments and finance of such [capital-importing] countries.”<sup>82</sup> The notion that multinational corporations’ property rights are contingent upon whether the host economy is in economic crisis has carried over into contemporary host government-foreign firm relations, though it remains a sticking point. For example, a multitude of foreign investors have sued Argentina in public IIAs, in response to the government’s adverse actions during its early 2000s economic crisis. The government has argued that it had the right to break contracts during a stated public economic emergency. The outcomes of these IIAs are far from providing a consensus on when foreign investors’ property rights might end, if ever.

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<sup>80</sup> Text from the draft as of summer 1986. Correa and Kumar 2004.

<sup>81</sup> Ibid. Paragraph 9.

<sup>82</sup> Ibid. Paragraph 27, 29.

While these stipulations would strengthen host governments' positions vis-à-vis the freedom of action of foreign firms, Paragraph 10 in particular faced strong opposition from capital-exporting countries. It makes steep demands of foreign firms:

10. Contracts between Governments and transnational corporations should be negotiated and implemented in good faith. In such contracts, especially long-term ones, review or renegotiation clauses should normally be included. In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract or agreement was based, transnational corporations, acting in good faith, shall/should co-operate with Governments for the review or renegotiation of such contract or agreement.

In short, the draft Code instructs multinational corporations to allow governments to renege on and renegotiate contracts when there has been an undefined "fundamental change of circumstances." Requiring firms to recognize that governments have a fundamental right to renegotiate contracts *ad hoc* inserts unmistakable risks into foreign firm property rights and the sanctity of their contracts with the host government. Forced contract renegotiation is a relatively common form of creeping expropriation, and it is coded as such in this dissertation; this provision would have made this coding false. From a multinational corporation's point of view, one can see why fungible contracts would be anathema.

While these rights for host governments failed to make it into a UN Code, they reappear in host governments' justifications for breach of contract. For example, host governments have claimed that their adverse actions toward foreign firms rightfully privilege domestic over foreign firms in economic development strategies; facilitate the growth of foreign exchange; or allow the host society to more equitably share in the rents when commodity prices spike. One may likely have normative opinions on these or other justifications for breach of contract. Regardless, governments in capital-exporting countries

have proved unwilling to enter into a multilateral legal regime that trades political risks to their firms' property for the codification of such sovereign autonomy.

### **Multilateral institutions for political risk management**

While it is not likely that a multilateral legal regime for FDI will emerge,<sup>83</sup> international organizations have been successful in setting up multilateral institutions to facilitate the flow of capital if not its legal status. The World Bank's Multilateral Investment Guarantee Agency (MIGA), founded in 1985, provides political risk insurance that helps enable FDI in risky capital-importing countries. Plans to create MIGA were accelerated by the early 1980s debt crisis in emerging economies, after which the World Bank saw particular need to facilitate foreign investment as an alternative to more sovereign loans to defaulting governments.<sup>84</sup> MIGA's insurance exists alongside private political risk insurance as well as insurance subsidized by national governments, such as that provided by the US Overseas Private Investment Corporation (OPIC), founded in 1971.

In the mid 1960s, the World Bank established the International Center for the Settlement of Investment Disputes (ICSID), the first public, international arbitration tribunal dedicated to hearing investor-state disputes.<sup>85</sup> Before ICSID, private, foreign firms had no standing to bring cases against sovereign governments before an international organization body.<sup>86</sup> Indeed, firms with international trade disputes do not have standing

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<sup>83</sup> Young and Tavares 2004.

<sup>84</sup> Baker 1999.

<sup>85</sup> Other forums in which investor-state disputes are heard include the Arbitration Institute of the Stockholm Chamber of Commerce, the International Court of Arbitration through the International Chamber of Commerce, and the London Court of International Arbitration. International investment arbitration also takes place on an *ad hoc* basis using rules issued by the United Nations Commission on International Trade Law (UNCITRAL) in 1976 and updated in 2010. In contrast to arbitration at ICSID, parties generally have the option of keeping litigation at these other courts and under UNCITRAL rules confidential.

<sup>86</sup> Sutherland 1979: 371.

at the WTO, as dispute resolution is a state-to-state affair. ICSID came about after the World Bank itself chose to intercede as arbiter in a dispute between the City of Tokyo and French bondholders over a loan repayment in 1964, as well as after the Egyptian Government nationalized the Suez Canal Company in 1966.<sup>87</sup> Rather than continue to play this role, the World Bank housed this arbitration responsibility in ICSID. However, ICSID heard very few cases from its inception through the 1980s. It was the rise of a new set of bilateral treaties that facilitated the more recent influx of cases.

## **BITs and breach of contract today**

From 1990 to 2009, some 41 emerging economies have nationalized approximately 150 foreign-owned firms. At least a handful of states have nationalized property each year, though the annual numbers are far lower than those of the 1970s (see Figure 2).<sup>88</sup> On the whole, however, breach of contract in recent decades has dealt with variants of creeping expropriation. Creeping expropriation has been increasingly visible thanks to the quick rise in the number of states sued by foreign investors over various forms of breach of contract in public international investment arbitration in forums like ICSID. Foreign investors have filed over 310 public IIAs against host governments for unlawfully devaluing their holdings.<sup>89</sup> These IIAs typically deal with forced contract renegotiations, regulatory infringements, discriminatory policy changes, and other undue interference with foreign firms' operations. Figure 3 indicates the spread of breach: 94 different emerging economies

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<sup>87</sup> Sutherland 1979: 374.

<sup>88</sup> Even when host governments transfer ownership away from foreign investors, they may do so only until the government has a blocking or controlling share in the foreign firm.

<sup>89</sup> Hajzler 2012, Minor 1994. United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed January 2012.

have been public respondents from 1990 to 2009. As seen in Figure 3, many suits have been brought against Latin American states. Argentina presently has faced the most suits, as a result of the 2001-2002 devaluation of the peso and concomitant government non-payment of many of its direct obligations to foreign investors. The countries of Central and Eastern Europe, too, have faced a high number of public IIAs. This is particularly 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. Of course, the process to move from an adverse government action to a public IIA is highly selective in likely idiosyncratic ways. Thus, government actions that end up in international arbitration represent only a slice of the population of broken contracts.

In public dealings around nationalizations and IIAs, governments continue to cite a multitude of rationales for breach, some of which are reminiscent of past justifications. Breach of contract has been a means of achieving political and economic goals like generating populist and economic nationalist support, but also a means to supplement government budgets, update regulations, and enact foreign policy. For example, Evo Morales, who was later to become president, gained prominence in Bolivia when he capitalized on local and national protests to win the “water war” in 2005. Morales revoked the American investor Bechtel’s contract to operate the water and sewage system in the town of Cochabamba, as punishment for Bechtel having increased rates and suspended services to customers in arrears.<sup>90</sup> Ecuador has similarly broken contracts with several foreign firms as part of an ethos of economic nationalism and protest over the distribution of rents between foreign firms and the domestic polity. In 2004, Peru used its right to

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<sup>90</sup> Forero, Juan. “Who Will Bring Water to the Bolivian Poor?” *The New York Times*: 15 December 2005.

collect taxes as justification for charging a Chinese fish flour manufacturer for a tax debt of approximately US\$4 million and imposing a tax lien on the firm's bank accounts, despite the fact that a legal challenge was pending. Chapters 5 and 6 discuss other instances in which government breach of contract results in increased tax revenue. Re-regulation has stood behind several disputes between foreign mining companies in African nations like the Democratic Republic of Congo, Mali, Ghana, and Burkina Faso. Host governments have used both the desire to upgrade environmental standards and concerns over the fairness of profit sharing as justifications for changing regulations and causing breach of contract. Bilateral political tensions and foreign policy concerns contributed to the Ukrainian government breaking (and remaking) contracts with Russian investors in oil and gas throughout the late 2000s. While breach can of course be a means for government officials to derive direct, corrupt benefits from their positions of authority, it has also been about host governments choosing domestic policy goals over foreign interests.

That governments today, as yesterday, are sometimes interested in breaking contracts with foreign firms for any of a variety of reasons is not surprising. What is surprising is the fact that governments continue to sometimes follow through and break contracts. For, since the late 1980s, changes in the world economy have liberalized capital flows, giving foreign firms more opportunities to invest overseas but also more opportunities to forego a risky location in favor of a safe one. Since the late 1980s, the choice to focus on FDI as a means of economic development has become all but standard in emerging economies. Figure 4 characterizes these two trends. Annual FDI inflows to emerging economies have grown quickly in recent decades. While ebbs and flows in annual numbers are inevitable, the cumulative effect is that FDI stock in emerging economies has

grown rapidly. The second trend, of a renewed commitment to FDI as a means of promoting economic development, is captured by the second set of data in Figure 4: the spread of Bilateral Investment Treaties (BITs).

While governments in capital-exporting countries have not codified their firms' property rights abroad under a multilateral legal regime, they have not given up the fight. A dense network of Bilateral Investment Treaties (BITs) has come to substitute for a multilateral regime of investor property rights protections. BITs are bilateral instruments signed between nation-states. The vast majority of BITs contain few if any legal obligations of foreign investors toward host governments, and the protections commonly provided in BITs include many of the points capital-importers refused to agree to in multilateral negotiations. BITs generally provide foreign investors the guarantee of national treatment as well as most favored nation treatment, so that foreign investors from all home countries receive treatment identical to the best treatment offered to any nationality of investors.<sup>91</sup> BITs also limit restrictions on exchange controls, ensuring foreign firms can repatriate capital. Requirements for prompt, adequate, and effective compensation for expropriated investments are also standard. The procedural right to sue host governments directly in international arbitration is to legal scholars the most vital and unique component of BITs; often, foreign investors can file public IIAs without first exhausting local courts.<sup>92</sup> It is this procedural right, combined with the existence of forums like ICSID, that have allowed more and more foreign investors to sue host governments outside of the domestic courts of the

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<sup>91</sup> Non-discrimination is generally required "post-establishment," or after foreign investments have been made in the host economy. 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.

<sup>92</sup> Franck 2007, Yackee and Webb 2008.



host country. In fact, home governments may not even know when or how their investors are using a BIT, particularly when IIAs are private. BITs thus straddle a line between interstate treaties and host government-foreign firm contracts. They codify many of the implicit commitments host governments make when allowing foreign firms to operate on their soil, and they provide a mechanism through international arbitration to bring instances of government breach of contract to light.

Why have emerging economy governments come to accept the constraints of BITs, if attempts to codify the same constraints in multilateral settings have been so unsuccessful? As multilateral efforts to codify foreign firm rights continued, BITs spread slowly: Germany and Pakistan signed the first BIT in 1959, but only 386 treaties were signed by 1989, mostly by Western European countries. The United States started pursuing BITs only in the 1980s, at which time it gave up its longtime focus on Friendship, Commerce, and Navigation treaties. The US choice to pursue BITs helped to legitimate BITs as “the policy tool of choice” for all countries.<sup>93</sup> With emerging economies looking to private foreign firms for external capital after the 1980s debt crisis, conditions were right for BITs to take off (see again Figure 4). BITs became the popular device through which to commit to foreign firms, and the credibility of BITs was enhanced by the diplomatic and FDI deterrence costs that could come with BIT violations. As an emerging economy’s neighbors signed BITs, a state faced greater incentives to likewise incur “sovereignty costs” in order to remain a competitive destination for foreign investment.<sup>94</sup> In this way, terms to which capital-importing governments had refused to agree *en masse* under a multilateral legal regime

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<sup>93</sup> Jandhyala et al 2011.

<sup>94</sup> 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.

nevertheless diffused across capital-exporter – capital-importer country pairs. BITs signed between capital-importers, or South-South BITs, began to spread in the late 2000s. By 2011, over 2600 BITs had been signed. Over 250 other bilateral economic agreements, including the 1994 North American Free Trade Agreement (NAFTA) and other Preferential Trade Agreements, also contain investment chapters with protections similar to a BIT.<sup>95</sup>

As BITs spread, especially in the 1990s and 2000s, so too did the incident of public IIAs brought by foreign investors against emerging economy host governments (see Figure 5). Like the nationalizations of prior decades, breach of contract at stake in these IIAs has occurred in a variety of industries. As summarized in Table 5, utilities and oil and gas firms account for 38 percent of the 355 publicly recorded IIAs heard from 1987 to 2008, but the remainder of public IIAs are distributed over ten other industries. It is important to remember that these public IIAs are a select group of instances when certain foreign investors see host governments as having broken their contracts. In these cases, several conditions hold: foreign investors have access to a BIT or another mechanism through which the host government has committed to international 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 both parties are willing to make the dispute visible to other current and potential foreign investors. This means, for example, that not every instance of expropriation noted in Figure 2 results in a public IIA. Many disputes make it into national

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<sup>95</sup> Salacuse 2010. Manger (2009) argues that multinational corporations interested in investing abroad have incentives to lobby for Preferential Trade Agreements (PTAs), so as to earn market share and first-mover advantages thanks to discrimination against firms from non-member countries. As of December 2009, 287 other economic cooperation agreements include investment provisions of some sort, though not necessarily the scope covered by BITs. James Zahn, Presentation. *50 Years of Bilateral Investment Treaties Conference 2009*.

newspapers but not the international legal system.<sup>96</sup> Some broken contracts may be common knowledge to interested investors but may not make it into business media. Still others are kept private by firms. Therefore, these public IIAs should be thought of as the tip of the iceberg of government breach of contract. Nevertheless, with the rise of BITs and public IIAs, a wide set of government breaches of contract have been legalized and publicized as never before.

If BITs now encode foreign firm rights, and carry penalties for breaking them, why have they not conclusively stopped the incidence of government breach of contract? Some international legal scholars argue that national governments uphold international law, such as treaty commitments, when it is formal and legalized.<sup>97</sup> In this vein, Simmons argues that making legal commitments to the IMF allows governments to “preserve their reputation for predictable behavior in the protection of property rights.”<sup>98</sup> Others see the empirical coexistence of breach and formal legalization and call this view naïve.<sup>99</sup> Abbott and Snidal, for example, argue that the presence or absence of normative covenants created by “soft law” can be just as decisive in explaining whether or not, say, a treaty commitment is upheld.<sup>100</sup> 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.”<sup>101</sup> To the extent that the

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<sup>96</sup> Such disputes are the focus of chapters 5 and 6 on Ukraine, Moldova, and Romania.

<sup>97</sup> Chayes and Chayes 1993.

<sup>98</sup> Simmons 2000: 820.

<sup>99</sup> Goldsmith and Posner 2005.

<sup>100</sup> Abbott and Snidal 2000.

<sup>101</sup> Salacuse and Sullivan 2005: 5 [emphasis in original].

second half of this bargain does not hold, there is less reason to expect BITs to conclusively stop host governments from breaching contracts with foreign firms.<sup>102</sup>

In fact, the evidence on whether BITs successfully attract increased foreign investment is mixed at best: some find little evidence of increased FDI,<sup>103</sup> while others find only conditional evidence that BITs increase FDI.<sup>104</sup> The relative invisibility of BIT benefits to analysts, let alone policymakers, has led several host governments to question their commitments.<sup>105</sup> Pakistan, South Africa, Bolivia, Ecuador, Nicaragua, and Venezuela have been publicly skeptical of BITs; since 2008, Bolivia, Ecuador, and Venezuela have withdrawn from some (though not all) investment treaties.<sup>106</sup> Following a US “awakening of sorts” that being sued might be more trouble than it is worth, the United States, Canada, and Mexico agreed on limits to arbitrator discretion under NAFTA’s Chapter 11.<sup>107</sup> As Simmons puts it, “For many governments the dream of attracting capital has dissolved into an ugly reality of litigation...The most predictable consequence of committing to a BIT has not been a burst of new investment, but rather litigation.”<sup>108</sup> The coexistence of breach and BITs highlights the limits of international law alone as a source of explanation for variation government breach of contract with foreign firms. The scholarly literature, on the whole, has looked elsewhere.

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<sup>102</sup> This also presumes that the knock-on costs BIT violations might have in other issue areas are sufficiently low.

<sup>103</sup> Hallward-Dreimeier 2003; Tobin and Rose-Ackerman 2004; Yackee and Webb 2008; Poulsen and Aisbett 2010.

<sup>104</sup> Salacuse and Sullivan 2005; Neumayer and Spess 2005; Tobin and Rose-Ackerman 2006; Kerner 2009.

<sup>105</sup> Young and Tavares 2004.

<sup>106</sup> Van Harten 2010: 2-5.

<sup>107</sup> Free Trade Commission (NAFTA), Notes of Interpretation of Certain Chapter 11 Provisions, 30 July 2001.

<sup>108</sup> Simmons 2010.

## Scholarly explanations

The best “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, when plotting public IIAs as an indicator of breach against rule of law rankings, no such simple relationship emerges (see Figure 6). If participating in a globally integrated economy requires governments to respect the preferences of foreign firms, how is it that host governments continue to sometimes breach contracts with foreign firms, whether their overall respect for rule of law is high or low? Under what conditions can and do emerging economy governments breach contracts with foreign firms?

Contemporary international political economy literature on FDI has focused on the host country governing institutions associated with FDI and political risks, finding some regimes better able to make credible commitments to foreign firms than others. An older literature on the “obsolescing bargain” focuses on the characteristics of foreign-owned assets themselves, identifying variation in the ease with which governments can appropriate them.<sup>109</sup> Both approaches treat foreign firms as black boxes. As the research presented in this dissertation suggests, it is necessary to take account of variation among foreign firms to explain why governments, of all stripes, sometimes breach contracts with foreign firms in a variety of industries.

### Regime type

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<sup>109</sup> Vernon 1971.

A considerable research effort has focused on the effects of regime type on a state's behavior as an FDI host. Jensen finds much evidence that FDI moves together with democracy, breaking down an early argument that foreign direct investors are drawn to authoritarian regimes.<sup>110</sup> For example, Jensen finds that multinational firms investing in democratic regimes, particularly with highly constrained executives, enjoy lower expropriation insurance premia.<sup>111</sup> Further, US multinationals restrict the size of their operations in more autocratic countries.<sup>112</sup> On the other hand, Li and Resnick find that it is not democracy as a whole but respect for property rights that moves with FDI, and they argue that policy uncertainty created by democratic institutions actually deters FDI.<sup>113</sup> With this possible caveat with regard to stability, this work as a whole suggests that democracies should be less likely to breach contracts as they are reasonably the set of regimes with closer adherence to the rule of law and more constrained executives.<sup>114</sup>

Consistent with this work, Humphreys and Bates find that more political competition and more checks on the executive predict less extractive policies in African countries.<sup>115</sup> In an analysis of nationalization events from 1960 to 1990, Li finds support for the argument that instability is detrimental to FDI, showing that democracies with higher executive turnover were more likely to expropriate than other democracies although democracies as a whole are less likely to expropriate than autocracies.<sup>116</sup> At the same time, countries with more veto points were less likely to expropriate, consistent with

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<sup>110</sup> Jensen 2002, 2003, 2006. O'Neal 1994.

<sup>111</sup> Jensen 2003, 2006, 2008; Jensen and Young 2008.

<sup>112</sup> Jensen 2008.

<sup>113</sup> Li and Resnick 2003.

<sup>114</sup> See also Henisz 2002 [2010].

<sup>115</sup> Humphreys and Bates 2005.

<sup>116</sup> Li 2009.

other findings on the role of executive constraints.<sup>117</sup> Li also complicates things, finding some evidence that longer leader tenure in autocracies decreases the incidence of nationalization and providing new support for the O'Neal argument that stable autocracies can be attractive investment destinations.<sup>118</sup> When focusing on mineral sector nationalizations in particular, Duncan finds that autocratic governments were actually less likely to expropriate than democratic ones, particularly in times of commodity price booms when democracies face particular pressure to redistribute wealth.<sup>119</sup> Indeed, given that foreign firms do sometimes invest in autocracies, and autocracies do not always break contracts, future research can provide a better perspective on how foreign firms respond in real time to local political conditions.<sup>120</sup> In short, while substantial evidence sits behind the connection between democracy and contract sanctity, the mechanisms linking political institutions and contract sanctity have been found in autocracies as well.

Development level may further complicate relationships between regime type and government breach of contract with foreign firms. It could be that breach is tied to the quantity of contracts, and the poorest countries simply have fewer contracts to breach. Jodice carried out the first multivariate regression analysis of nationalization events, using data from 1968 to 1976, and found that poorer and more war-torn countries were more likely to nationalize.<sup>121</sup> Similarly, Cai and Treisman argue that governments in worse-endowed countries may give up on investment attraction and instead focus on predation and satisfying local demands, as they cannot compete with well-endowed, business-

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<sup>117</sup> Ibid.

<sup>118</sup> O'Neal 1994.

<sup>119</sup> Duncan 2006. See also: Guriev et al 2009. 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.

<sup>120</sup> Along these lines, see Gelbach and Keefer (Forthcoming).

<sup>121</sup> Jodice 1980.

friendly countries.<sup>122</sup> However, *ex ante* predictions are not so clear, as the poorest countries also have the most incentives to make credible commitments to access foreign capital. In a world where FDI flows into even the least developed countries have been increasing, perhaps the bleak scenario laid out by Cai and Treisman does not hold.

### **Obsolescing bargain**

In contrast to work on political regimes, literature on the “obsolescing bargain” considers the relationship between breach and the characteristics of foreign-owned assets. Developed by Vernon, the obsolescing bargain logic argues 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.<sup>123</sup> Governments can take over productive investments from investors who 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.”<sup>124</sup> The more sunk costs an investor incurs, the less mobile the investor, the less credible the investor’s exit options, and thus the less credible the government’s contractual commitment.<sup>125</sup>

Breaking foreign firms into groups of “mobile” and “immobile” investors is one way to understand why government breach of contract need not always aggregate into economy-wide costs. Frieden determines that site-specific investments, which are easily

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<sup>122</sup> Cai and Treisman 2005.

<sup>123</sup> Vernon 1971.

<sup>124</sup> Vernon 1971: 47. Despite the obsolescing bargain, successful investors are enticed to remain in-country “by the sinking of commitments and by the sweet smell of success” (53).

<sup>125</sup> Moran 1973.



seized and for which rents are concentrated, are subject to extensive initial sunk costs.<sup>126</sup> Such investments are effectively immobile, and a private, foreign investor into immobile assets faces the problem of the obsolescing bargain and easy expropriation.<sup>127</sup> Scholars have applied obsolescing bargain logic to explain changing relations between Namibia and the diamond giant De Beers,<sup>128</sup> the early 1970s copper firm nationalizations in Zambia and Zaire,<sup>129</sup> oil and gas nationalizations,<sup>130</sup> and even relatively immobile manufacturing firms in India.<sup>131</sup> Others have extended the obsolescing bargain framework to model the dynamism of declining expected future discounted returns for the foreign firm over time;<sup>132</sup> to account for bargaining between home and host countries, or multilateral institutions and host countries, that sometimes precedes private FDI;<sup>133</sup> to explain the role non-governmental organizations (NGOs) can play in international investment;<sup>134</sup> or to suggest dynamic contractual clauses like progressive taxation that allow for a “fair” reallocation of assets over time.<sup>135</sup>

Throughout these applications and extensions, the backbone of the obsolescing bargain remains that some immobile firms are more captured than other, nimble firms. Moreover, these unlucky firms are usually operationalized by industry.<sup>136</sup> But increasing evidence shows that industry is not a sufficient proxy for investor mobility. For example, more and more contemporary FDI is seeking local market entry and not production and

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<sup>126</sup> Frieden 1994.

<sup>127</sup> Moran 1974, 1998.

<sup>128</sup> Kempton 1997.

<sup>129</sup> Shafer 1983.

<sup>130</sup> Hajzler 2011.

<sup>131</sup> Vachani 1995.

<sup>132</sup> Thomas and Worrall 1994.

<sup>133</sup> Ramamurti 2001.

<sup>134</sup> Nebus 2009.

<sup>135</sup> Land 2009.

<sup>136</sup> Cf. Wolf 2004, Henisz 2002 [2010].

cheap export. Some firms are tied to foreign markets through social networks, as in diaspora investment.<sup>137</sup> Market-seeking foreign firms that self-select into risky emerging economies are relatively immobile, especially when they sink significant assets into retail and distribution networks, for instance. Western European banks expanding into Eastern Europe have “no where else left to go” and have been seeking investment locations that provide them the greatest market power if not the most efficiency.<sup>138</sup> And, regardless of the properties of assets in an industry, a competitor’s broken contract might be a boon for another foreign firm’s local business prospects, thus prompting the firm to reinvest rather than exit. Given that so many firms’ threats of exit are compromised, across and within industries, an obsolescing bargain approach alone makes it difficult to understand why breach does not always occur. Moreover, the obsolescing bargain also underestimates the extent to which even investors in vulnerable industries can cancel planned projects or stop reinvestment in a host country, providing them at least some ongoing capital mobility and thus bargaining power over a host government.<sup>139</sup>

While obsolescing bargain logic has been applied to the bargain between a particular foreign firm and the host government, its implications for other (immobile or mobile) foreign firms’ expectations of government breach of contract remain unexplored. On the one hand, obsolescing bargain arguments imply that a broken contract, with even a relatively immobile investor, increases risks that all foreign firms will be subject to opportunism by the host government, for now that the government has more resources at

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<sup>137</sup> Leblang 2010. Bandelj (2008) argues that executives draw on social networks and cultural understandings to undertake foreign investments. 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.

<sup>138</sup> Lanine and Vander Venne 2007. Interviews (4), foreign banks, Ukraine, Romania, and Moldova.

<sup>139</sup> Likosky 2009.

hand that could offset costs of future breaches.<sup>140</sup> On the other hand, a given foreign firm's broken contract may signal increased risks to only other investors in the same industry, or only to immobile investors, or even no other investors, if the expropriated firm's situation were to provide no relevant signals to other foreign firms. To clarify which if any of these suppositions characterizes how breach of contract affects a host government's standing with other foreign firms, and thus other foreign firms' investment decisions, we need a fuller theory of which investors are deterred when a government breaks a contract. The next section introduces an axis of variation along which, this dissertation will go to show, foreign firms vary in their ability and willingness to act in ways costly to the host government following a given breach of contract.

## **National diversity among foreign firms**

One trend in FDI continues to change the players in the game of foreign firm-host government relations. Whereas once foreign firms came from the United States, the United Kingdom, and a handful of Western European countries with particular ties abroad, these countries' share as sources of FDI is declining. The introduction of new nationalities of firms into global capital flows creates variation among firms that directly impacts the likelihood of government breach of contract and suggests that, all else equal, the incidence of breach will increase over time.

Figure 7 summarizes recent trends in the national origins of FDI. In 1980, US firms accounted for the biggest share of outward FDI, but their share has steadily declined as total FDI outflows have risen quickly in the last decades. The shares of outward FDI flows

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<sup>140</sup> Jensen and Johnston 2011.

of Japan as well as major European capital-exporters, including Germany, France, the Netherlands, and the United Kingdom, have remained relatively stable. Instead, other home countries have thus contributed to the quick rise in world FDI. Figure 8 summarizes data from the International Monetary Fund (IMF), a major reporter of FDI statistics. The IMF reported data from 15 capital-exporters in 1980, but by 2006 some 94 countries reported positive outward FDI. In a cross-national dataset collected in 2009, in the midst of worldwide financial crisis, 84 countries still reported outward FDI including 65 emerging economies that accounted for 27 percent of world FDI outflows.<sup>141</sup> While firms from OECD capital-exporting countries (which are the focus of the data in this dissertation) are still the bulk of those making contracts with host governments, increasing investor diversity is the norm. This includes the increasing diversity of flows from sources within the OECD as well.

Table 6 summarizes the increasing diversity of multinational corporations' nationalities in one sector, banking, over just the short period of the 1990s and 2000s. Traditional OECD countries continue to account for the lion's share of multinational banks. But the number of multinational banks coming from other home countries in Asia, Europe, Latin America, the Middle East, and Africa doubled from 1995 to 2009. This expansion holds true even when excluding banks from eight countries that often serve as home countries "of convenience" for foreign capital.

Table 7 shows the diversity of outward stocks from, and inward stocks to, the expanded 27-member European Union from 2004 to 2008. FDI between the EU and advanced industrialized countries, including the United States, Switzerland, Canada, Japan, and Norway, accounts for a large share of total FDI stocks in and out of the EU. EU FDI also

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<sup>141</sup> International Monetary Fund, *Inward Direct Investment Positions*, 2009.

flows into a great variety of destinations. This data reflects what we know about the great diversity of countries in which advanced industrial countries (a category that includes most but not all EU-27 members) invest. In the second column of the table, however, we see that a variety of countries account for FDI inward stocks in the EU. Significant amounts of FDI stock come from the Middle East, Brazil, Singapore, Russia, and even Uruguay. This cross-section of FDI stocks gives yet another impression of the trend toward more diversity among sending countries.

The trend of increasing national diversity among multinational corporations is not wholly limited to recent decades. Figure 9 displays counts of the foreign manufacturing subsidiaries of major American, European, and Japanese multinational corporations since the early 1900s. US firms increased their manufacturing activities abroad over the period, especially in the 1960s, but so too did British and Continental European firms. Japanese firms grew from effectively no foreign manufacturing activity in the early 1900s, to substantial activity in the 1960s. Today, Japanese manufacturers represent major foreign firms, especially in Asian emerging economies. Emerging economy countries, too, have been home to multinational corporations in the past. By the late 1970s, 963 emerging economy parent firms had established subsidiaries and branches in at least 125 countries.<sup>142</sup> Table 6 summarizes the outward foreign investment position of fourteen emerging economies in the late 1970s. Hong Kong, Singapore, and the Philippines were the largest capital-exporters of this group, although several Latin American countries also had positive outflows of FDI to a number of foreign subsidiaries.

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<sup>142</sup> Wells 1983: 2.

When considering Latin American countries as hosts to FDI, US multinationals clearly dominated inward FDI until the mid 1950s. Over the next ten years, however, non-American firms grew to include one-third of all new foreign capital. In the 1970s, FDI diversified further, thanks in particular to investments from West German, Japanese, Swiss, Canadian, British, and French firms. Using methodology employed in chapter 4 of this dissertation, a weighted measure of the effective number of foreign investor nationalities present in Brazil grew from 3.9 in 1969, to 6.4 in 1974 and 7.2 in 1982, meaning that FDI nationality diversity in Brazil increased considerably.<sup>143</sup> From an environment in which foreign capital came from a small number of home countries, by the early 1980s more and more nationalities of foreign firms were present across Latin America.

The growth of multinational corporations in more and more home countries is not surprising. As Dunning laid out in his “eclectic paradigm,” firms choose to become multinational as a result of ownership, internalization, and locational factors.<sup>144</sup> Ownership factors include the firm’s management style, advantages the firm might derive as a result of its particular home country, and the firm’s historical legacy. Traditional home countries have robust support structures for internationally minded firms, but there is no reason that such characteristics cannot develop in other countries, too. Internalization factors are those aspects of a firm that lead it to keep investments in-house (internal) as opposed to participating in the global economy through external contracting or strictly trade relationships. One could imagine firms finding internalization advantageous regardless of national origin. In fact, the relatively weaker intellectual property protections in emerging

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<sup>143</sup> Data from Lipson 1985: 106. Reported values are indices, where FDI nationality mix =  $1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ . See chapter 4 for details.

<sup>144</sup> Dunning 1980.

economies might make multinational corporations from those countries particularly likely to internalize rather than risk licensing relationships.<sup>145</sup> As with ownership factors, there is not reason to believe that internationalization factors are limited to firms coming from traditional capital-exporting advanced industrialized countries.

Locational factors, the third set of factors that lead firms to become multinationals, account for the distribution of foreign direct investors' current and potential investments across different host countries. Those investors willing to invest in emerging economies are willing to trade-off more locational risk in exchange for potentially higher rewards. In the distribution of all possible foreign investors from risk-seeking to risk-averse, it is improbable that all risk-seeking firms originate in advanced industrialized countries like the US and Great Britain. In fact, investors from emerging economies might have particular advantages when investing in emerging economies. Multinational corporations from non-traditional countries may have products better targeted to markets in emerging economies, be better able to navigate red tape and bureaucratic holdups common in such countries, or be more geographically proximate to host countries. These characteristics would suggest that non-traditional foreign investors would be more likely to invest in emerging economies than their traditional counterparts.<sup>146</sup> The takeaway here is that there is nothing intrinsic about firms outside of the United States and Western Europe that prevents them from being foreign investors themselves, and foreign investors into emerging economies in particular. The increasing national diversity of foreign investors over the twentieth century corresponds to the growth and internationalization of trade and finance more generally.

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<sup>145</sup> Wells 1983.

<sup>146</sup> Ibid.

With foreign investors from more home countries bringing more cultures, histories, languages, and business practices into emerging economies, host governments have to take more bilateral relationships into account when interacting with foreign firms. The clash between host government sovereignty and foreign firm property rights plays out across more and more home-host country pairings. The spread of foreign investors from more countries, to more countries coincides both with the worldwide incidence of breach of contract and the deep economic integration that globalization continues to bring about.

## **Conclusion**

Host governments have long interacted, and sometimes clashed, with foreign firms. The tension between accessing foreign capital in capital-scarce economies and maintaining sovereignty is constant. Since the late 1980s, however, a policy of eschewing foreign capital has fallen out of favor. Thus host governments continue to make contracts with new foreign firms of increasingly diverse national origins. But, host governments continue to break contracts, in a variety of ways: nationalization, breach of written and implicit contracts, and, now, violations of Bilateral Investment Treaties (BITs).

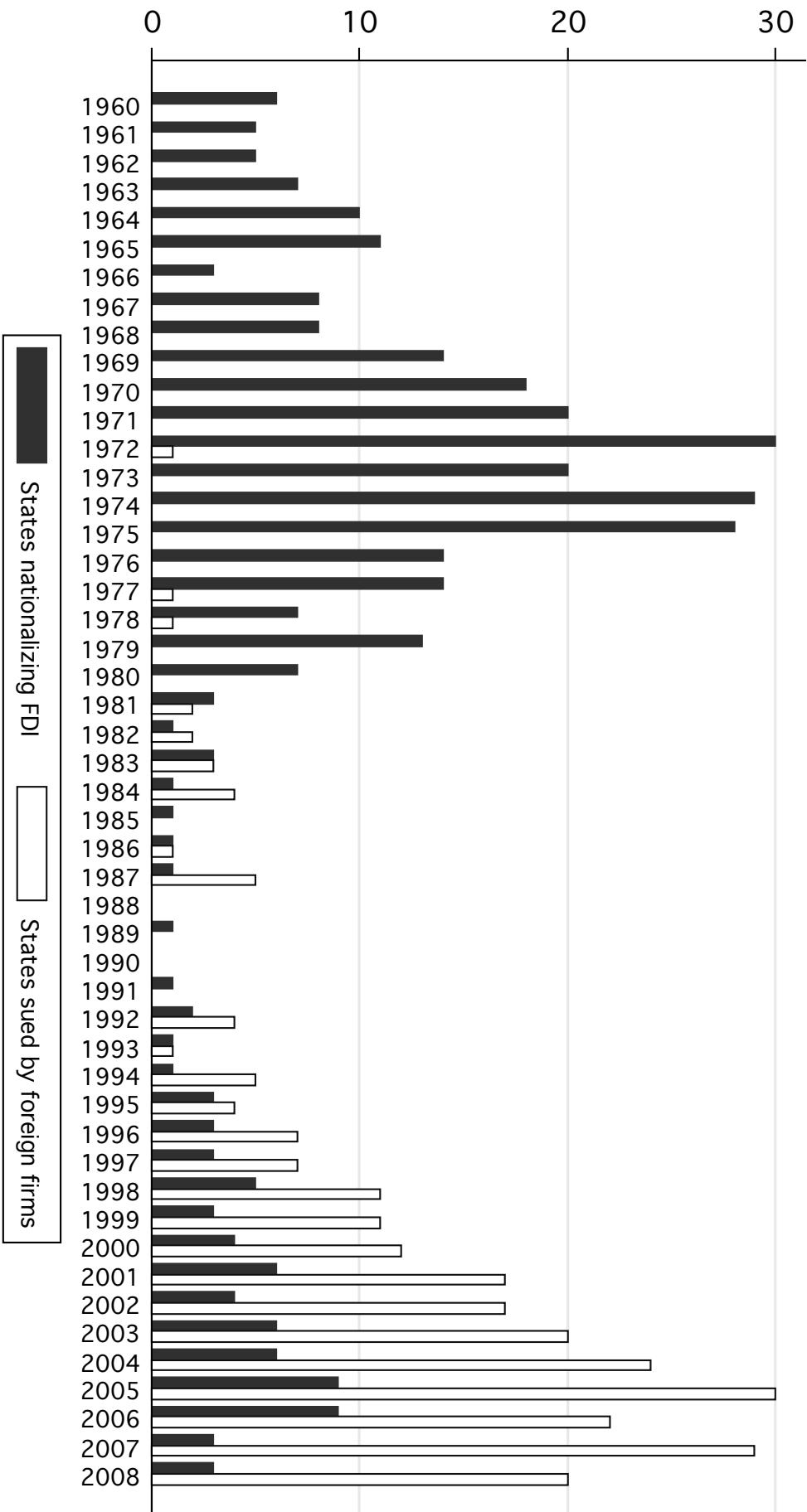
Explanations for breach of contract that focus on the effects of political institutions on contract sanctity or the mobility of foreign assets overlook how the costs of breach aggregate. Does a breach of contract with one foreign firm increase risks to all foreign firms? A theory of foreign firms' reactions to not just their own but also other foreign firms' broken contracts is necessary to understand both why breach ever happens and why it does not always happen. In the next chapter, I argue that the growing diversity of investors divides the risks of breach of contract to different national subsets, in turn facilitating the



current state of affairs: breach and contract sanctity coexisting in emerging economies, alongside increasing FDI.



**Figure 2. Annual count of emerging economies breaking contracts with foreign firms, 1960-2008**



Sources: Hajzler 2012; Kobrin 1980, 1984; Minor 1994. United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed January 2012.

**Table 1. Regimes that nationalized property in banking, natural resources, services, and manufacturing (1960-1985)**

Years	Country	Head of Government	Acts	No. of firms
1965-1978	Algeria	Boumedienne	33	107
1975-1978	Angola	Neto	15	128
1974	Benin	Kerekou	4	10
1962-1983	Burma	Ne Win	10	24
1970-1973	Chile	Allende	30	46
1970-1977	Congo	Ngouabi	10	31
1969-1978	Democratic Yemen	Robaje	5	30
1956-1967	Egypt	Nassere	7	70
1975-1978	Ethiopia	Mengistu	26	105
1959-1979	Guinea	Toure	7	9
1967-1975	India	I. Gandhi	6	48
1957-1965	Indonesia	Sukarno	15	24
1979-1980	Iran (Islamic Republic of)	Khomeini	17	58
1968-1977	Iraq	al-Bakr/Hussain	7	8
1972-1977	Jamaica	Manley	7	12
1969-1974	Libyan Arab Jamahiriya	Qadaffi	11	33
1975-1978	Madagascar	Ratsiraka	12	50
1965-1975	Morocco	Hassan	13	30
1975-1980	Mozambique	Machel	18	43
1967-1974	Nigeria	Gowon	7	35
1968-1975	Peru	Velasco	28	47
1970	Somalia	Barre	5	10
1971-1976	Sri Lanka	Bandaranaike	6	254
1970-1978	Sudan	Nimeiri	13	25
1969-1981	Trinidad and Tobago	Williams	9	10
1970	Uganda	Obote	5	9
1963-1978	Tanzania	Nyerere	28	127
1964-1980	Zambia	Kaunda	20	21
<i>Total</i>			374	1404

Sources: Kennedy 1992; Kobrin 1980, 1984.

**Table 2. Sectoral distribution of expropriation events in emerging economies, 1960-1976**

	<b>Sector</b>	<b>Percent of total actions</b>	<b>Sectoral FDI stock (US\$ millions)*</b>	<b>Sectoral share of total FDI stock</b>	<b>Relative vulnerability to expropriation<sup>^</sup></b>
Banking and insurance	60	11.8	610	1.7	6.80
Agriculture	47	9.3	2046	5.8	1.59
Other <sup>^^</sup>	51	10.0	2360	6.7	1.49
Public Utilities	31	6.1	1581	4.5	1.36
Mining and Smelting	64	12.6	3658	10.4	1.21
Manufacturing	138	27.2	10831	30.8	0.88
Petroleum	95	18.7	11270	32.1	0.58
Trade	22	4.3	2773	7.9	0.55
<i>Total</i>	<i>508</i>		<i>35129</i>		

\*FDI stock as of 1976

<sup>^</sup>Takes the Percent of Total expropriatory actions / Sectoral share of total FDI

<sup>^^</sup> Other includes construction, services, transportation, and communications.

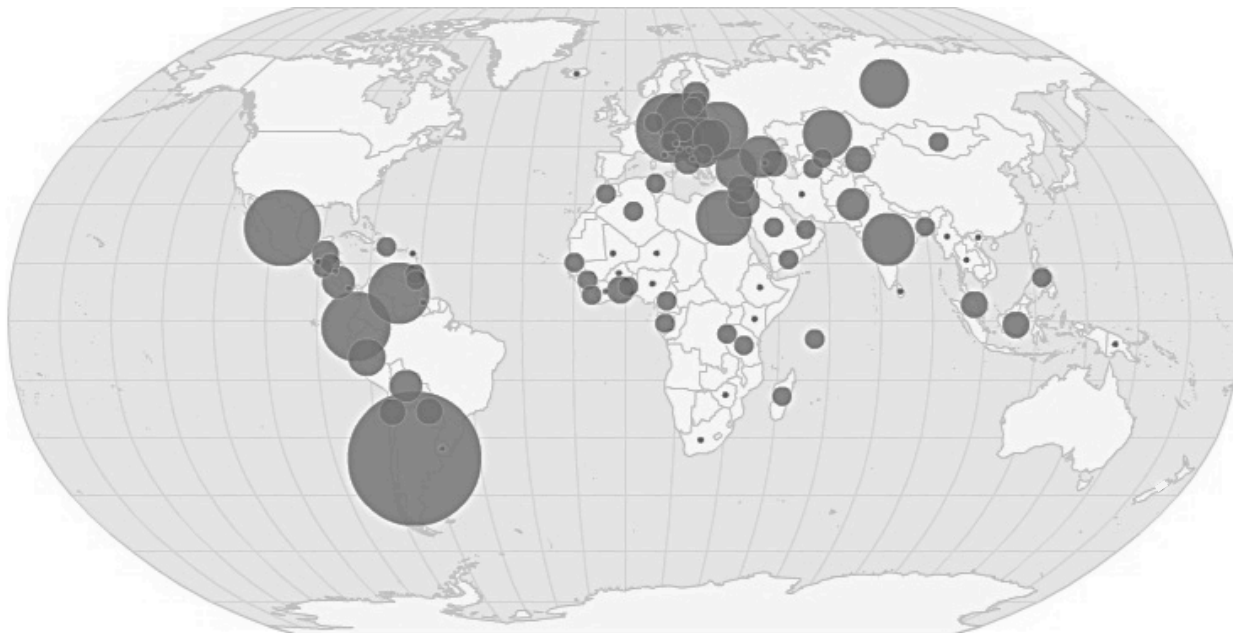
*Source:* Jodice 1980: 182 (Table 1).

**Table 3. Industry characteristics of expropriations of 170 American firms in emerging economies, 1946-1973**

		1946-1960	1961-1966	1967-1971	1972-1973
<i>By industry:</i>	Extractive	50	50	39	37
	Financial	0	5	28	18
	Manufacturing	0	27	27	40
	Utilities	50	18	6	5
<i>By selectivity of takeover:</i>	Entire industry, mixed	33	0	8	19
	Entire industry, foreign	42	68	38	28
	Selected firms, no industry specification	8	0	21	16
	Selected firms, within an industry	17	32	33	37

*Source:* Hawkins, Mintz, and Provissiero 1976: 9 (Table 1).

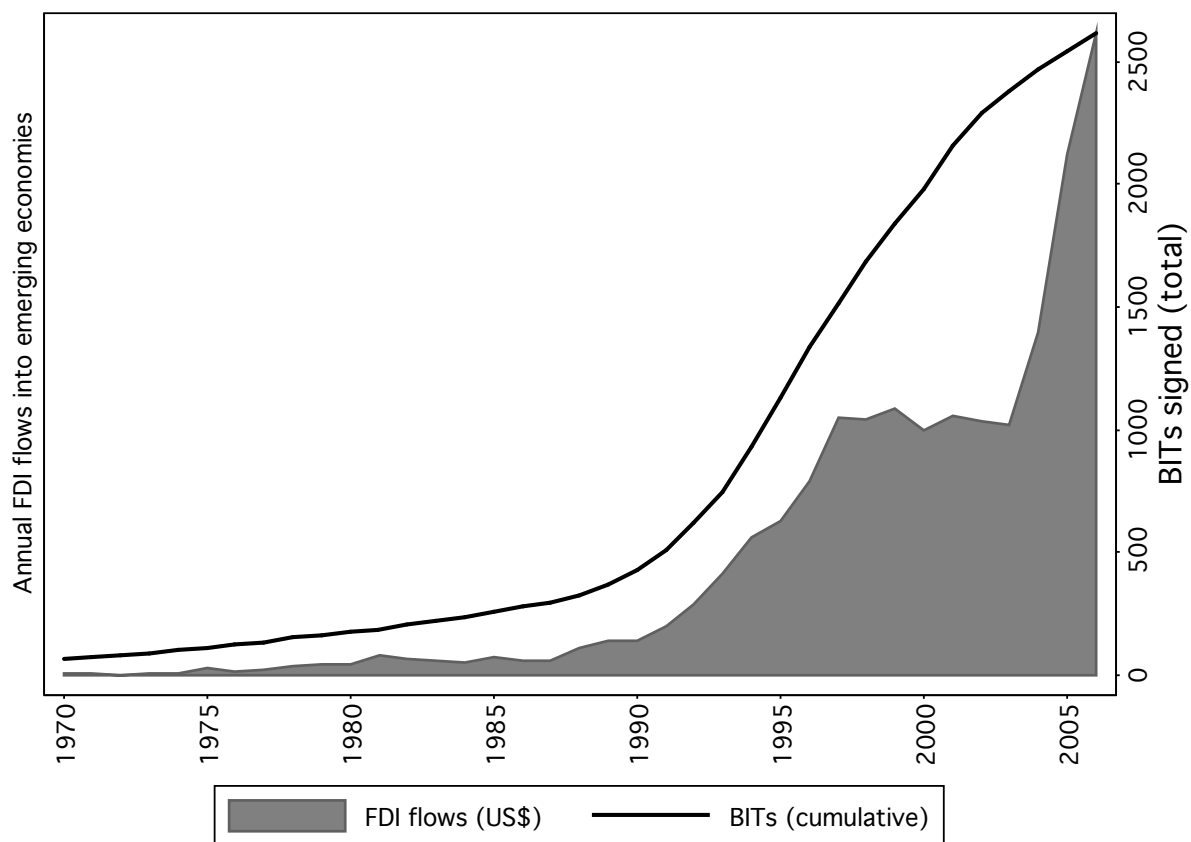
**Figure 3: Public international investment arbitrations (IIAs) brought by foreign investors against emerging economy host governments, 1990-2009 (count)**



Argentina: 53 public IIAs.

Map facility from [manyeyes.alphaworks.ibm.com](http://manyeyes.alphaworks.ibm.com). Data on publicly disclosed IIAs is taken from the United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed January 2012.

**Figure 4. FDI flows into emerging economies and number of Bilateral Investment Treaties (BITs) signed**



*Sources:* Annual FDI flows are World FDI less flows to World Bank-classified high income countries. World Bank World Development Indicators; UNCTADstat ([www.unctadstat.unctad.org](http://www.unctadstat.unctad.org)).



**Table 4. Summary of attempted multilateral agreements on the treatment and regulation of foreign investment, 1907-2010**

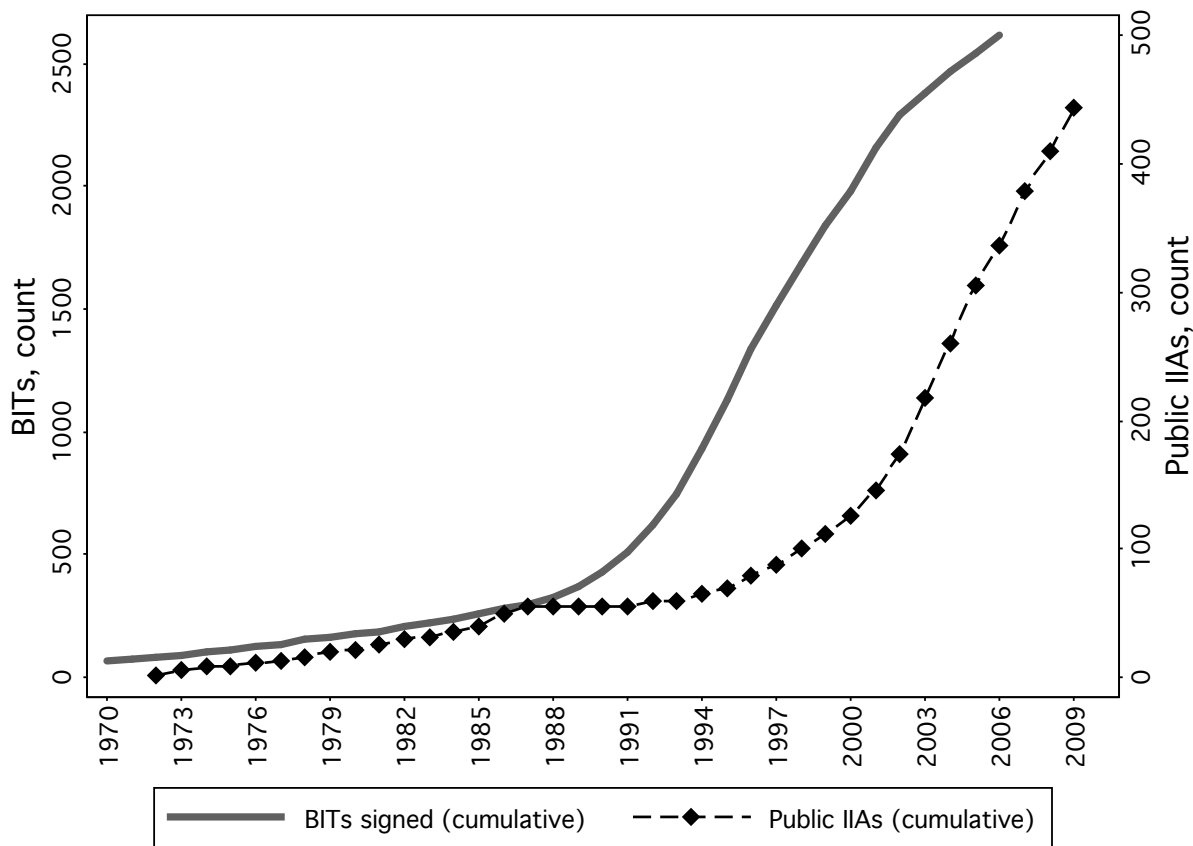
Agreement	Organization	Initiated	Contents	Status
The Porter Doctrine	Hague Peace Conference (44 countries)	1907	Creditors agreed not to collect contract debts by force if debtor states would accept binding arbitration.	Latin American states entered major reservations; ratified only by Mexico.
International Conference on Treatment of Foreigners	League of Nations	1929	Attempt to codify international property law confirming "national treatment" for foreign investment, or equality between foreign and domestic investments. European powers wanted clear statement that compensation must be according to international minimum standards.	Defeated by a coalition of Latin American, Eastern European, and ex-colonial states.
Conference for the Codification of International Law	The Hague	1930	Negotiations over imposing responsibility for protecting foreign investment. No discussion of areas in which host government could still assert sovereignty.	Proposed convention vetoed by India, Latin American and East European states.
Codification of Calvo Clause	Seventh Inter-American Conference	1933	Attempt to codify proposition that foreigners t conducting local commerce, just as domestic citizens, must forgo the right of appealing to their home governments for support.	Latin American states agreed. Rejected by the United States, which specifically reserved its rights to the contrary under international law.
Charter	International Trade Organization	1945-1948	1946 draft charter referenced the rights of investors and obligations of host states but did not address investment security. In 1947-1948, the US delegation proposed inclusion of requirement for "prompt, adequate, and effective compensation."	Negotiations failed. Opposition to US amendments from Latin America, India, and Australia delegations. Proponents of foreign investment withdrew support because of strong emphasis on sovereign rights.
General Assembly Resolutions on Permanent Sovereignty over Natural Resources	United Nations	1952 - 1966	Introduced by Uruguay and Bolivia. Endorsed the right of all states to nationalize and freely exploit natural resources. Word "nationalization" dropped from final version. Final 1952 version includes non-binding recommendation that member states "have due regard, consistent with their sovereignty, to the need for maintaining the flow of capital in conditions of security."	Non-binding Resolutions with no international legal standing. 1962 Resolution diluted compensation standards from "just compensation" to "appropriate" payments. 1966 Resolution deleted all references to international law.

Convention on Settlement of Investment Disputes between States and Nationals of Other States	World Bank	1965	Intended to facilitate the flow of investment from industrialized to developing countries by providing investment arbitration facilities, through the International Center for the Settlement of Investment Disputes (ICSID).	Came into force in 1966.
Set of Multilaterally Agreed Equitable Principles and Rules for Control of Restrictive Business Practices (RBPs)	UN Conference on Trade and Development (UNCTAD)	1968	Voluntary recommended norms stating that enterprises should follow host country RBP laws; provide information on business practices to host governments; and refrain from collusion, predatory pricing, etc.	Adopted unanimously in 1980. Considered ineffective by UNCTAD review groups.
General Assembly Resolution 3041/XXVII	United Nations	1972	Resolution that nationalization is "the expression of sovereign power...in virtue of which it is for each state to fix the amount of compensation and the procedure for these measures." Disputes were to fall "within the sole jurisdiction" of the nation's courts.	Non-binding resolution with no international legal standing.
Charter of Economic Rights and Duties of States	United Nations	1974	Outlined rights of developing countries and duties of multinational firms and home countries. Endorsed restrictions on foreign capital in developing countries, including the exclusive use of municipal courts to settle disputes.	Non-binding resolution with no international legal standing. 120 in favor; 10 abstained; 6 against (US, UK, West Germany, Denmark, Belgium, and Luxembourg).
Guidelines on International Investment and Multinational Enterprises	OECD	1976	Voluntary recommended norms of behavior for foreign firms and host governments, including provisions on information disclosure, environment, combating bribery, tax policy, employment and industrial relations, etc.	Adopted in 1976, revised in 1991 and 2000. No legal standing.
Tripartite Declaration of Principles on Multinational Enterprises and Social Policy	International Labor Organization (ILO)	1977	Voluntary recommended norms regarding employment, training, working conditions, and industrial relations for foreign firms and host governments.	Approved in 1977 by ILO Governing Body, amended in 2000. No legal standing.
UN Code of Conduct on Transnational Corporations	UN Economic and Social Council	1977	Established standards for the conduct of foreign firms and their treatment by host governments, covering national treatment, transparency, nationalization and compensation, etc.	Negotiations abandoned in 1992. Recommended seeking alternative methods to manage investor-host country relations.

International Code of Conduct on Transfer of Technology	UN Conference on Trade and Development (UNCTAD)	1977	Intended to facilitate and increase technology transfer by prohibiting restrictive business practices and recognizing a sovereign right of states to facilitate and regulate technology transfer.	Negotiations abandoned in 1985. Developed countries opposed legally binding code.
Convention Establishing the Multilateral Investment Guarantee Agency (MIGA)	World Bank	1985	Provides political risk insurance. Also provides advisory services on the legal framework for FDI in member host countries.	Adopted in 1985. MIGA established in 1988 at the World Bank. Effective source of political risk insurance.
Agreement on Trade-Related Investment Measures (TRIMs)	WTO	1986	Applies only to investment measures related to trade in goods. Member countries maintain rights to regulate FDI, except with regard to trade-related performance requirements such as local content or trade balancing requirements. Developing countries required to eliminate TRIMs within five or seven years.	Adopted in 1995.
General Agreement on Trade in Services (GATS)	WTO	1986	Applies to investment measures affecting trade in services.	Adopted in 1993.
Energy Charter Treaty	The Hague	1991	Treaty confirms national sovereignty over energy resources and protects foreign firms against discriminatory treatment and breach of contract.	Legally-binding instrument with 51 signatories in 2011 (Russia withdrew 2009)
Multilateral Agreement on Investment (MAI)	OECD	1995	Legally binding treaty to ensure protection and legal rights for foreign firms. Was to ensure national treatment and most favored nation status to foreign firms in both pre-and post-investment phases.	Negotiations abandoned in 1998.
Multilateral Framework on Investment	WTO	1996	EU and Canada pushed for a Possible Multilateral Framework on Investment (PMFI) with the OECD MAI as a model.	Working Group on Trade and Investment studied the issue without a negotiating mandate.

Sources: Lipson 1985, Correa and Kumar 2003, original documents.

**Figure 5. Public IIAs brought against emerging economies and number of Bilateral Investment Treaties (BITs) signed**



As of 2009, a total of 444 public IIAs had been brought against emerging economies.

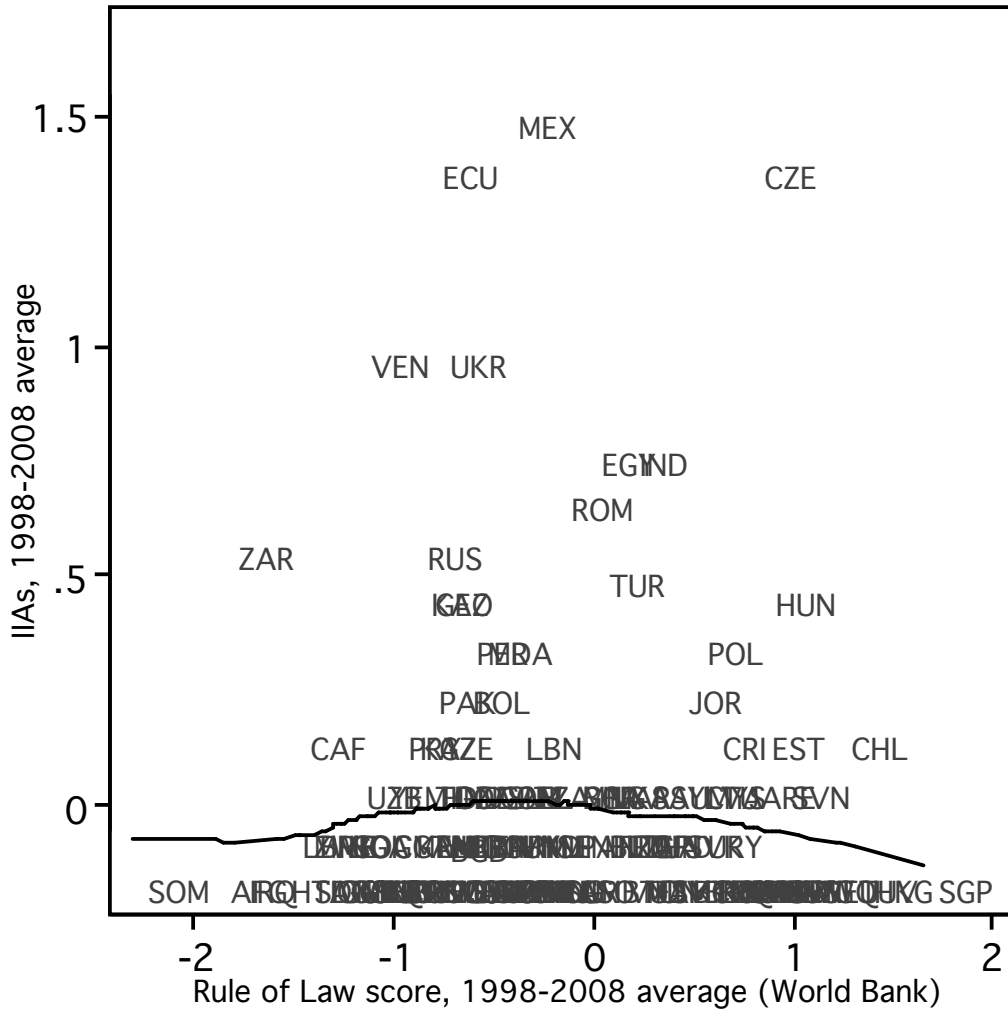
Data on publicly disclosed IIAs is taken from the United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed January 2012.

**Table 5. Public international investment arbitrations (IIAs) brought against emerging economies, 1987-2008, by sector of claimant**

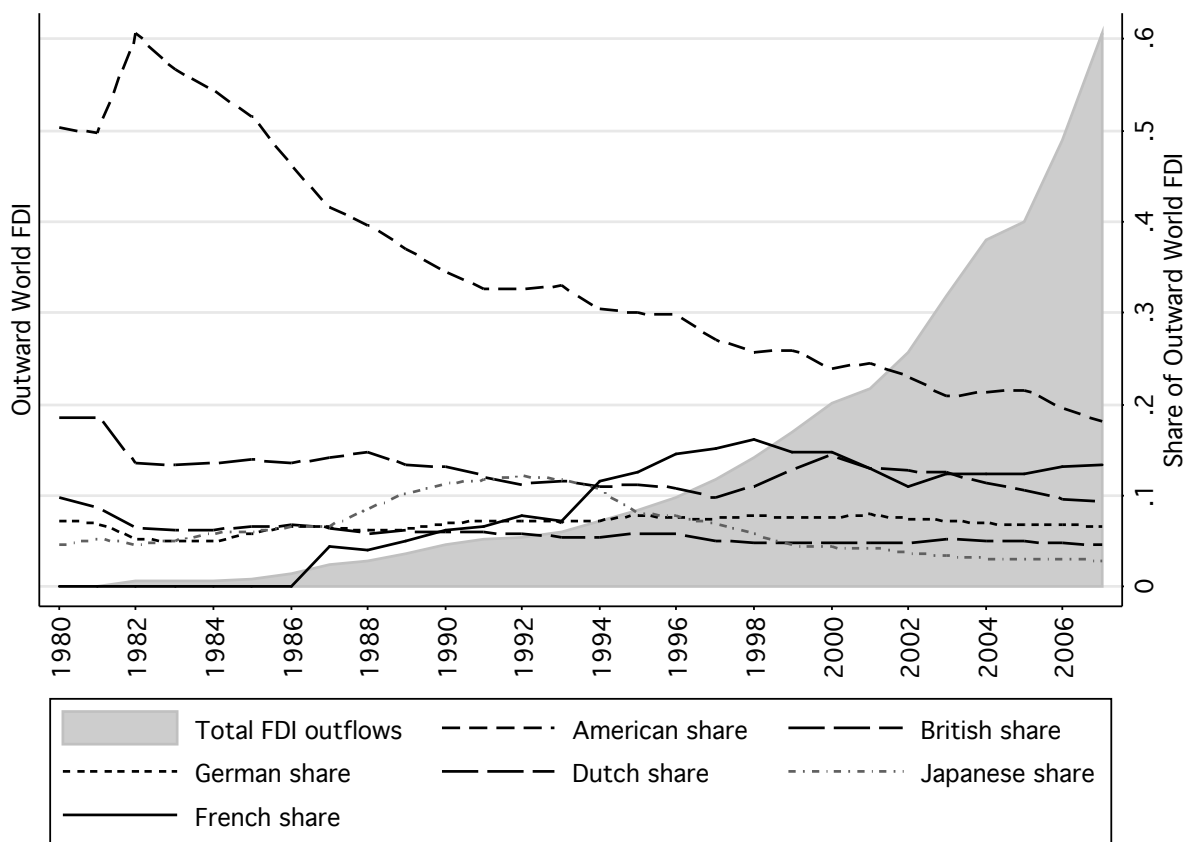
<b>Sector</b>	<b>Count</b>	<b>Percent</b>
Utilities	72	20.3
Oil and gas	64	18.0
Real estate	30	8.5
Banking	30	8.5
Services	29	8.2
Transportation	28	7.9
Manufacturing	26	7.3
Agriculture	21	5.9
Mining	20	5.6
Telecommunications	19	5.4
Media	8	3.1
Metals	5	1.4
Trade	3	0.8
<i>Total</i>	<b>355</b>	

*Source:* United Nations Conference on Trade and Development (UNCTAD) Database of Treaty-based Investor-State Dispute Settlement Cases (pending and concluded). International Arrangements Section, Division on Investment, Technology, and Enterprise Development. Accessed January 2012.

**Figure 6. Lowess smoother and scatterplot of annual international investment arbitrations (IIAs) brought against emerging economies and rule of law rankings, averaged 1998-2008**

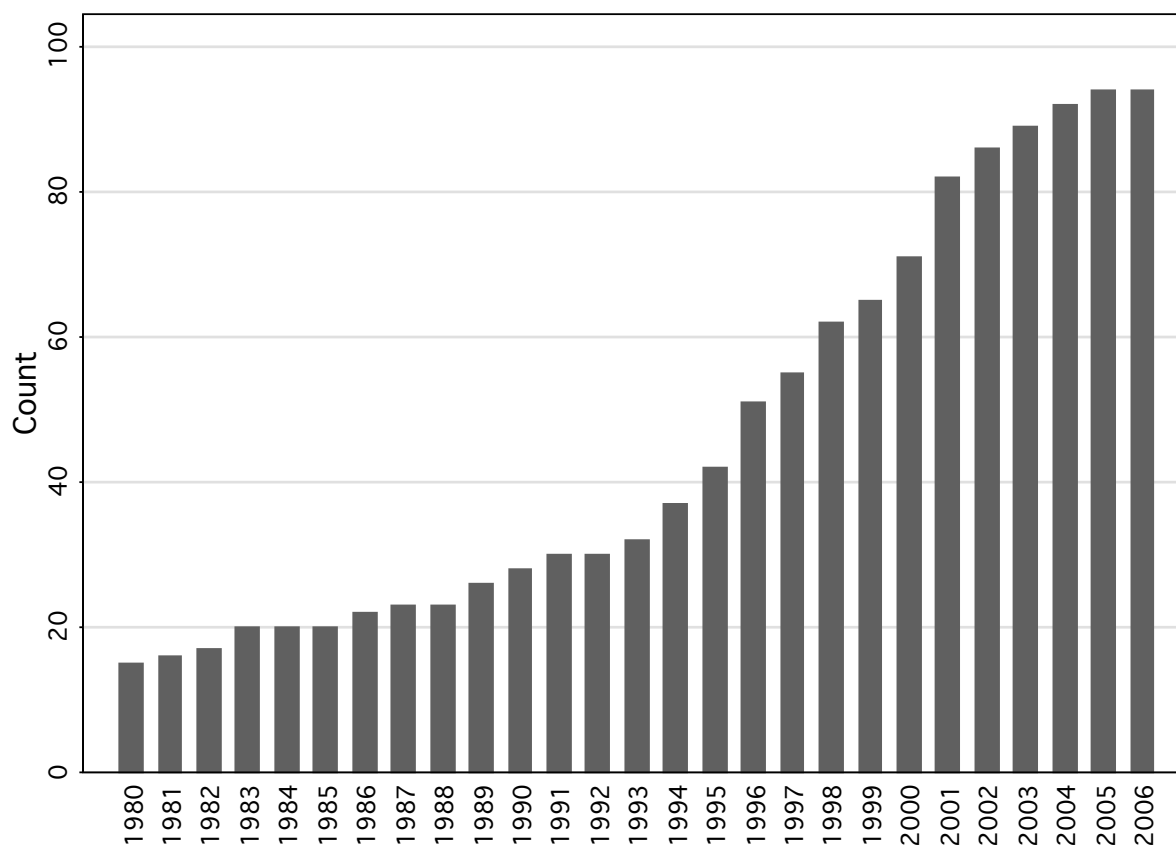


**Figure 7. Total World FDI outflows and traditionally large FDI home countries' shares (1980-2007)**



These countries accounted for 55 percent of world FDI outflows in 2007, down from 80 percent in 1987.

*Source:* International Monetary Fund, International Investment Position, Global Historical Statistics.

**Figure 8. Countries reporting outward FDI to the IMF (Annual count, 1980-2006)**

Source: International Monetary Fund, Balance of Payment Statistics.



**Table 6. Multinational banks by home region^ (count)**

	<b>Region</b>	<b>1995</b>	<b>2000</b>	<b>2005</b>	<b>2009</b>
<i>OECD:</i>	Western Europe	389	539	625	686
	United States and Canada	123	162	153	159
	Japan, Australia, and New Zealand	38	37	35	39
<i>Other:</i>	East Asia and Pacific	39	57	58	71
	Eastern Europe and Central Asia	25	55	69	85
	Latin America and Caribbean	64	76	65	62
	Middle East and North Africa	38	53	64	89
	South Asia	12	13	15	17
	Sub-Saharan Africa	29	37	57	81
	<i>Total</i>	757	1029	1141	1289

<sup>^</sup>Eight offshore host countries are excluded: Antigua and Barbuda, Bahrain, Barbados, Cyprus, Mauritius, Panama, Seychelles, Singapore.

*Source:* Van Harten 2011: 23 (Table 2).

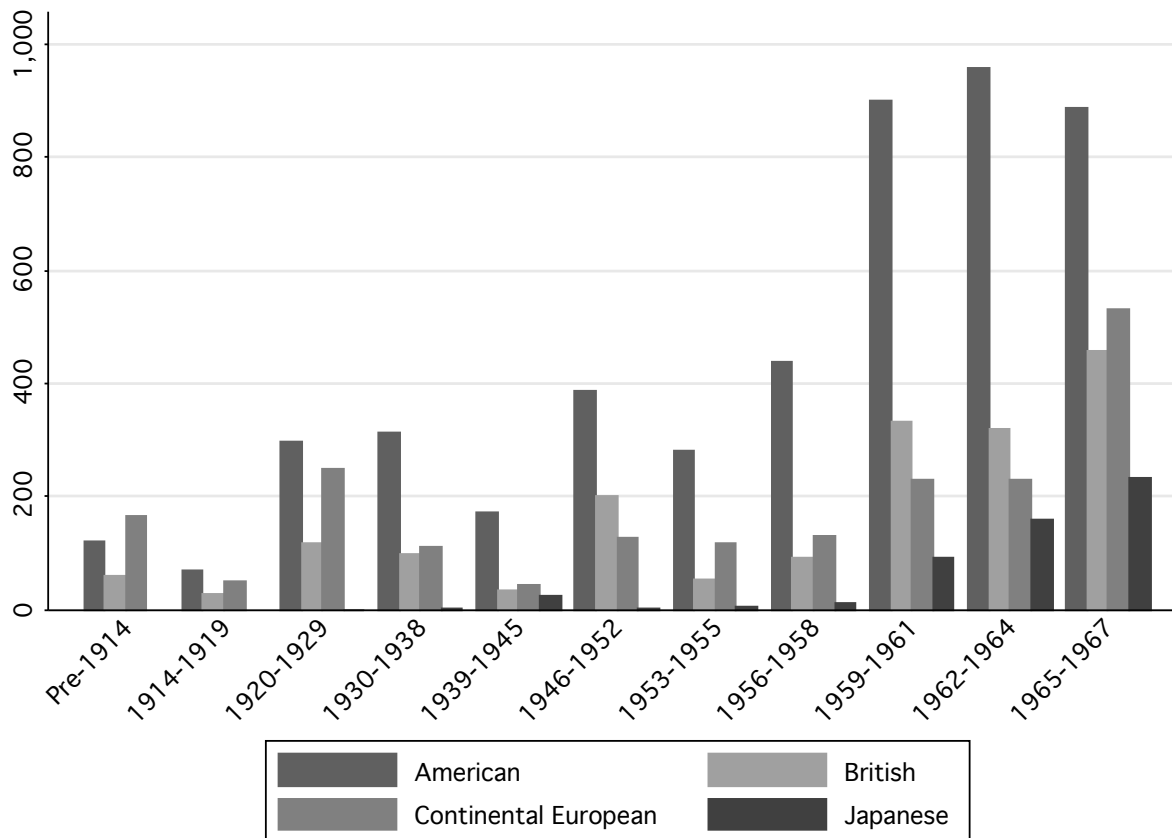
**Table 7. EU-27 outward and inward investment stocks (2004-2008) by extra-EU27 destination and country of origin**

Rank	Outward stocks		Inward stocks	
	Country of destination	Share in total extra-EU27	Country of origin	Share in total extra-EU27
1	United States	28%	United States	38%
2	Offshore financial centers	21%	Offshore financial centers	23%
3	Switzerland	10%	Switzerland	10%
4	Canada	5%	Gulf states*	7%
5	African, Caribbean and Pacific countries	5%	Japan	4%
6	Russian Federation	4%	Brazil	4%
7	Turkey	3%	Canada	4%
8	Singapore	2%	African, Caribbean and Pacific countries	3%
9	Brazil	2%	Australia	2%
10	Japan	2%	Singapore	2%
11	Hong Kong	2%	Russian Federation	2%
12	Gulf states*	2%	Norway	2%
13	China (excl. Hong Kong)	2%	Hong Kong	1%
14	Australia	2%	Iceland	1%
15	Mexico	2%	India	1%
16	Norway	2%	Mexico	<1%
17	South Africa	2%	Uruguay	<1%
18	Egypt	1%	South Africa	<1%
19	Ukraine	1%	Egypt	<1%
20	India	1%	China (excl. Hong Kong)	<1%

^Gulf states: United Arab Emirates, Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, Yemen

Source: "The EU Approach to International Investment Policy after the Lisbon Treaty." 2010. *Directorate-General for External Policies: Policy Department*. European Parliament: 22.

**Figure 9. Foreign manufacturing subsidiaries established by major<sup>^</sup> American, British, Continental European, and Japanese multinational corporations (Count, 1914-1967)**



<sup>^</sup>This includes the subsidiaries of parent firms that made the *Fortune* list of the largest 400 US firms in 1967 or the *Fortune* list of the largest 200 non-US firms in 1970. This includes 187 American firms, 49 British firms, 94 Continental European firms, and 66 Japanese firms. The manufacturing subsidiaries of Japan's largest 10 trading firms are included as well.

Source: Tsurumi 1976: 2 (Table 1-1).

## Chapter 3: National Diversity of the Investor Community and Contract Sanctity

Many scholars and citizens 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 in which foreign investment is vital 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.<sup>147</sup> Others have identified issue areas where domestic policymakers still exercise some autonomy, such as labor and environmental regulation.<sup>148</sup> These domains are 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 they converge on the demand for the protection of private property rights and the institution of rule of law has gone virtually unquestioned.

From a foreign firm's point of view, the most relevant component of rule of law in a destination country is the sanctity of contracts with the host government itself. Host governments contract with foreign firms in a variety of ways: 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

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<sup>147</sup> Rodrik 2011, 1997; Kobrin 2001, Strange 1996.

<sup>148</sup> Mosley 2011, Murphy 2004, Vogel 1997.

agreements; and they have signed over 2600 Bilateral Investment Treaties (BITs) that protect foreign firm property rights under the force of international law. When the host government credibly commits to uphold its contracts, foreign firms invest and reinvest, supporting local economic development through tax dollars, job creation, and technology transfer. Without contract sanctity, the expectation has been that foreign firms will 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 while still attracting foreign investment. 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. Since 1990, over 94 emerging economies have been accused of breach of contract by foreign firms in public, legalized settings. Some 150 investments have been nationalized, and foreign investors have filed over 310 public IIAs against host governments for unlawfully devaluing their holdings.<sup>149</sup> These legal actions represent only a slice of what one multinational executive called pervasive instances of "everyday breach of contract" in emerging economies.<sup>150</sup> But emerging economy governments do not always break contracts, even when disputes arise. After two years of threats, Romania stopped its moves to nationalize a British-owned aluminum firm in 2007. In 2009, Ukraine backed off threats to break its contract with an American retailer. In spite of the secular increase in foreign direct investment (FDI) into emerging economies worldwide, the sanctity of contracts host governments make with foreign firms has varied across countries and over time. These puzzling contradictions prompt an examination of

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<sup>149</sup> See chapter 2 for discussion.

<sup>150</sup> Interview, foreign firm in financial services, Moldova, 2009.

the pressures emerging economy governments face to honor or break contracts with foreign firms.

Contrary to the conventional wisdom, nationality and nation-states are embedded in economic globalization at both 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 abroad for a variety of reasons. As explored in this chapter, nationality is structurally important to foreign firm property rights as it is a cornerstone of the modern, bilateral institutions that codify foreign investor rights. Moreover, bilateral politics spill over into investor decision-making, and home country business traditions shape the contracts firms enter into with host governments. These factors make firms of the same nationality more likely to share risks to their contract sanctity than firms of different nationalities. As a result, when the host government breaks a contract, firms of the same nationality take actions costly to the host government in response. These costly actions include FDI exit and diversion as well as protest exercised together with home country diplomats. In effect, co-national investors have the incentive and the means to come together to form a common shield to protect their contract sanctity. In contrast, firms of one nationality lack the incentive to risk their defenses on behalf of the contract sanctity of a firm of another nationality. This means that firms are unlikely to draw down or divert investments, much less engage in active protest, on behalf of a non-co-national firm. Therefore, the expectation that aggregate investor behavior automatically enforces foreign investors' contracts is flawed, because investor willingness and ability to act punitively toward a host government depends on nationality.

When moving from a firm-level analysis to the level of the economy as a whole, we see the surprising and counterintuitive implication of nationality's effect on contract sanctity. Greater nationality 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 by turning to other groups for current and future capital access. The set of foreign firms present in a host economy thus shapes the risks any given investor faces and the opportunities host governments have to capitalize on low costs to breach. When a country hosts a more diverse set of foreign firm nationalities, which we might take as a measure of being more widely integrated into the global economy, the surprising implication is that economic integration need not move together with increased respect for foreign firms' property rights. Instead, economic integration with more nationally diverse firms reinforces host government's national autonomy, including the autonomy to act contrary to rule of law.

In this chapter, I explore why and how national origin matters to foreign firms' contract sanctity abroad and to investors' access to resources with which to protest breach. I then explain how foreign firms' ability to deter breach depends on the mix of investor nationalities present in an economy. When the nationality diversity of the investor community is low, one nationality's differential drawdown of FDI in response to breach, as well as any lobbying efforts, has a bigger impact on the host government's overall access to foreign capital. In this environment, co-national investors can better exploit divisions generated within the host government by the financial, regulatory, populist, and other motives host governments have for breach. On the other hand, when the nationality

diversity of the investor community is high, a host government faces lower costs of breach with one nationality thanks to current and future FDI from other national groups. The result is that common national identity can be a source of power for foreign firms in their relations with host governments, but increasing FDI diversity generates opportunities for host governments to reconsider their commitments to foreign firm property rights.

### **National origin as a determinant of risks to contract sanctity**

Foreign firms observing a host government's breach of contract with another firm face the question: are they next, or can they 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. One set of negative reactions come in the form of investment diversion and firm exit, either wholly or in part when firms draw down investments or cancel planned reinvestments. 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: national origin. National origin differentiates the political risks faced by foreign firms, which makes firms more likely to respond negatively to government breach of contract with a co-national than otherwise.



The modern structure of foreign firm property rights embeds investor national origins in contract sanctity, as bilateral treaties have come to replace failed efforts to enact a multilateral regime that encodes and protects foreign firm property rights.<sup>151</sup> In the post-WWII era, IIAs, in which foreign investors bring lawsuits against a sovereign host government, has gained prominence.<sup>152</sup> International investment arbitration affords foreign investors the unprecedented ability to directly sue host governments without the approval of their home governments, which contrasts with the World Trade Organization's (WTO) dispute resolution system, for example. However, multilateral institutions have failed to come to consensus on exactly what foreign investors can sue over. The United Nations, World Bank, and others have tried and failed many times to codify into international law host governments' obligations toward foreign investors (and vice versa).<sup>153</sup> This lacuna enabled the growth of bilaterally negotiated treaties called Bilateral Investment Treaties (BITs). While some BITs were signed in the decades after WWII, since the 1990s they have come to nearly saturate advanced-emerging economy dyads and are spreading to emerging-emerging economy dyads. Some 2600 BITs now act as credible commitment devices as emerging economies compete to prove their adherence to investor property rights in the race for foreign capital.<sup>154</sup>

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<sup>151</sup> See chapter 2 for review.

<sup>152</sup> The most important public investment arbitration tribunal has been the International Centre for Settlement of Investment Disputes (ICSID), initiated by the World Bank in a 1966 treaty. 147 countries are ICSID members as of 2011. See chapter 2.

<sup>153</sup> The most recent failure was the Organization for Economic Cooperation and Development's (OECD) Multilateral Agreement on Investment, abandoned in 1998. For discussion, see chapter 2.

<sup>154</sup> Elkins et al. 2006. UNCTADstat ([www.unctadstat.unctad.org](http://www.unctadstat.unctad.org)). See chapter 2 for more information.

The consequence of this network of bilateral commitments is that national origin determines the international legal rights to which a firm has access.<sup>155</sup> Some observers argue that BIT provisions have converged; if this were true, BITs would constitute a *de facto* multilateral regime despite their bilateral legal basis.<sup>156</sup> But BITs are not interchangeable. 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, the treaties 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 international investment arbitration, thanks to differences in home and host government bargaining power.<sup>157</sup> 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.<sup>158</sup> BITs also vary in the extent of host government obligations to foreign investors and the circumstances under which host governments agree to international investment arbitration.<sup>159</sup> For example, 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 a cultural exception 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' acquisition

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<sup>155</sup> Multilateral treaties with clauses 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 IIAs. The vast majority of public IIAs have been facilitated by BITs.

<sup>156</sup> E.g., Elkins et al. 2006, Kerner 2009.

<sup>157</sup> Allee and Peinhardt 2011.

<sup>158</sup> Rudolf Dolzer. Presentation, "BITs Around the World: Different Substantive and Procedural Approaches." *50 Years of Bilateral Investment Treaties Conference 2009*.

<sup>159</sup> Blake 2010.

Dutch nationality by incorporating in the Netherlands.<sup>160</sup> 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 are relevant signals of contract sanctity in a way that claims made under other bilateral treaties are not. For firms without access to a BIT and without guaranteed international legal recourse, the operations of BITs are even more remote to contract sanctity. Structurally, then, investor national origins determine investors' property rights protections under international law.

Foreign firm nationality has long carried with it the burden or blessing of bilateral politics. 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. Varying attention translates into varying political risks to foreign firm contract sanctity. 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.<sup>161</sup> Analogously, bilateral FDI increases in the presence of a military alliance.<sup>162</sup> Emerging economies with an American troop presence receive more American-origin FDI but not more aggregate FDI.<sup>163</sup> These findings suggest that firm decision-making is influenced by bilateral political factors, and, further, that the investment choices of firms of different nationalities are not influenced by another's bilateral politics. While these are extreme scenarios of war and peace, further evidence suggests that firms take incremental

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<sup>160</sup> Rudolf Dolzer. Presentation, "BITs Around the World: Different Substantive and Procedural Approaches." *50 Years of Bilateral Investment Treaties Conference 2009*.

<sup>161</sup> Biglaiser and Lektzian 2011, Li and Vashchilko 2010.

<sup>162</sup> Li and Vashchilko 2010.

<sup>163</sup> Biglaiser and DeRouen Jr 2007.

changes in bilateral relations into account when making investment decisions, with firms increasing their required return on investment when diplomatic tensions heighten.<sup>164</sup> 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. 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 favor of foreign policy goals, which can make them more likely to invest in the riskiest emerging economies than private foreign firms. 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.

Bilateral ethnic, linguistic, and cultural ties influence the willingness and ability of host governments to breach contracts with certain groups of investors over 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.<sup>165</sup> Diaspora ties and cross-border social networks make it easier for firms to operate under informal and incomplete contracts, again leading to higher FDI flows.<sup>166</sup> Common language and colonial history are standard, positively signed controls in studies of the determinants of FDI. Scholars have also found that FDI flows are higher when countries have similar levels of

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<sup>164</sup> Desbordes 2010.

<sup>165</sup> Williamson 1979.

<sup>166</sup> Bandelj 2008, Leblang 2010.

corruption<sup>167</sup> and when countries have similarly egalitarian cultures, again with the argument that shared tacit knowledge facilitates more investment.<sup>168</sup> Because tacit and codified 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. Neither should broken tacit contracts signal the same political risks to counterparties that have different sorts of historical and cultural bargains underpinning their government relations. 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.

Host governments have played out high politics in their treatment of particular national groups of foreign firms. In the 1950s to 1970s, emerging economy governments frequently broke contracts with ex-colonial foreign investors; for example, 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.<sup>169</sup> 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.<sup>170</sup> Foreign firms in post-communist Europe understand that Russian-origin firms have different relationships with host governments in this not-quite-foreign region that Russia calls the “near abroad.”<sup>171</sup> Because politics in Eastern Europe is often tied up with host governments’ attitudes toward Russia, political turnover in countries in the region can

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<sup>167</sup> Wu 2006; DeBacker, Heim, and Tran 2012.

<sup>168</sup> Siegel et al 2010, 2012.

<sup>169</sup> Akinsanya 1981. See chapter 2 for more discussion.

<sup>170</sup> Stopford 1991.

<sup>171</sup> In Russian: *лижнее зарубежье*.

result in increased or decreased contract risks for Russian-origin firms. These dynamics behind British, French, or Russian contract sanctity in these cases differ from those faced by investors of other national origins. The implication is that changes in British, French, or Russian firms' contract sanctity provide little information to investors of other national origins in these contexts.<sup>172</sup> Domestic 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 mask their national origins, lest they be targeted for extra-contractual "tax payments."<sup>173</sup> 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, for example. The key addition made here, however, is to recognize that firms of other nationalities are unlikely to respond in costly ways following such bilaterally motivated diplomatic-via-economic actions.

A considerable research effort into international business practices has found that firms with the same national origin operate in similar ways abroad, embodying the formal and informal institutional constraints of their country of origin.<sup>174</sup> Co-national firm similarities extend to their investment strategies, the form of their contractual relations with the host government, and their reactions to new information on political risks. Scholars argue that the greater separation between home and host country cultural norms as well as regulatory and "cognitive" institutions, the more difficult it is for a nation's foreign investors to gain legitimacy with the host country polity and government.<sup>175</sup> Given

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<sup>172</sup> Interviews, various, Ukraine, Moldova, and Romania.

<sup>173</sup> Interview, Turkish firm, Moldova. Turkish investors do receive good treatment in Gagauzia, a sub-region in Moldova where the local population has Turkish roots. See chapter 6.

<sup>174</sup> North 1990, Holburn and Zelner 2010, Doremus et al 1999.

<sup>175</sup> Kostova and Zaheer 1999.

that a standard explanation for contract breach – whether from a government or from a private counterparty – is that the contract is illegitimate, a tie between national origins and local acceptance of a foreign investment points to shared risks to contract sanctity. One means by which firms can overcome potential disadvantages is by benefitting from a “legitimacy spillover” generated by early entrants of the same national origin that have already had time to cultivate acceptance.<sup>176</sup> The timing and order of national groups’ entry into an economy can thus be salient to each group’s contract sanctity. Additionally, firms with the same national origins are more likely to use the same kind of financing for their operations abroad, 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.<sup>177</sup> As a result, national origins influence a firm’s legal and financial exposure and, by extension, the direct costs a host government incurs when breaching a firm’s contract. Commonalities among co-national firms make them efficient sources of local knowledge for each other, able to communicate among themselves in culturally understandable ways.<sup>178</sup> 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 firms.<sup>179</sup> Such dynamics reinforce co-national firm ties. Ultimately, the home-host country relationship shapes the extent to which firms’ nationality-mediated business practices confer local advantages or disadvantages. Above all, these considerations differentiate national investor groups one from the other.

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<sup>176</sup> Ibid.

<sup>177</sup> Doremus et al 1999, Li et al 2011.

<sup>178</sup> Tan and Meyer 2011.

<sup>179</sup> Tan and Meyer 2011, Wells and Ahmad 2007.

A firm's national origins can also give a host country government and polity expectations about the contributions its investments will make to local goals. FDI provides capital to capital-hungry 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, and other direct contributions to local development.<sup>180</sup> 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.<sup>181</sup> 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 South-South investors. For example, Ukrainian officials are 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.<sup>182</sup> Multilateral organizations like the World Bank and European Union have spread the best practice of prioritizing FDI from particular home countries in hopes of gaining broader growth-promoting resources; generally, the targets for investment promotion are Western.<sup>183</sup> However, high expectations can incentivize host governments to break contracts with firms if investments do not result in the expected benefits. This dynamic sat behind the cancellation of American and Spanish firms' water and sewage contracts in Argentina and broadly in Asia in the early 2000s.<sup>184</sup> Local beliefs about the contributions a nationality's

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<sup>180</sup> Moran, Graham, and Blomström 2005.

<sup>181</sup> Ibid.

<sup>182</sup> Interview, academia, Ukraine.

<sup>183</sup> Loewendahl 2001. Interview, European Union consultant for Investment Promotion Agencies.

<sup>184</sup> See Post 2009.



FDI will make to domestic development make nationality relevant to the government's expectations of firms and, thus, to firms' contract sanctity.

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. Such multinational firms are often seen as the world's most powerful holders of leverage over host governments. Far from existing outside of national boundaries, however, these firms are made vulnerable to contract risks associated with more than one bilateral relationship. At the same time, these firms can leverage their multiple national origins by trading off between their different home countries' bilateral legal resources like BITs and, as explained below, by accessing multiple sets of diplomats and other nationality-tied resources. Firms with multiple national identities do not become "meta-national" but rather occupy several national groups that can influence their contract sanctity.

Foreign firms own office space in host countries and hang signs with company names that can evoke different stereotypes and histories in the minds of host country citizens. Firms of the same national origin operate within a nationality-specific definition of their legal rights as foreign firms, and they are more likely to conduct their operations using similar institutions and business practices. In these ways, 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 exit in response, whether by drawing down an existing

investment or diverting planned investments to a different country. Because bilateral legal, political, cultural, and operational realities impact firms' contract sanctity, firms of other nationalities are made indifferent to the broken contracts of another national group and are unlikely to exit in response to others' broken contracts. Thus, national origin intervenes in the claim that foreign firms leave when a host government breaks foreign firms' contracts.

*H1: All else equal, firms are more likely to draw down or divert FDI following a government breach of contract with a firm of the same nationality than otherwise.*

## **National origin as a resource for investor voice**

Foreign firms entering risky emerging markets take measures to protect their investments from political risks, including the risk of government breach of contract.<sup>185</sup> When new risks arise, however, investors have incentives to augment their existing strategies with additional "recuperation mechanisms" in order to recover previous levels of contract sanctity.<sup>186</sup> 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 is an expensive option of last resort. Firms choosing to exit or incrementally divert capital in response to changed risks must leave behind sunk capital and incur transition costs.

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<sup>185</sup> If indeed there were risks of government breach of contract in advanced industrial countries, the theory would travel to them. But the norm of contracting, the presence of robust legal institutions to which foreigners have access, and the generally strong rule of law in OECD countries make breach a non-issue on the whole. To the extent that there have been public, broken contracts in OECD countries, they have occurred between the US and Canada under the investment protections written into the North American Free Trade Agreement (NAFTA). The theory implies that the fall-out from these broken contracts is largely a bilateral affair with few risks suggested to foreign firms of other nationalities. Actors of other nationalities should therefore remain uninvolved in these disputes and their possible resolution. Indeed, one does not see other countries coming out in favor of either Canadian or US interests in these cases. In particular, Mexican actors do not provide explicit support for firms of other nationalities, although Mexican firms do have interests in the operation and scope of NAFTA provision.

<sup>186</sup> Hirschman 1970.

Even when foreign firms choose to exit, 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. Executives at foreign firms understand that exit is a complex decision and can be reluctant to attribute any particular exit to increased risks to contract sanctity.<sup>187</sup> Without this direct tie between breach and exit, host governments may not interpret changes in aggregate FDI statistics as a reflection on their decision to encroach on contracts. Moreover, when exit results in relative but not absolute losses of FDI, incumbent governments continue to benefit from increasing aggregate levels of FDI. The complex counterfactual reasoning of what might have been in the absence of government breach makes for a difficult opposition slogan. As many emerging economies have experienced a secular increase in FDI in the last decades, the situation of relative but not absolute FDI decline is pervasive. Thus, co-national exit alone may not sufficiently affect a host government's ability to remain in and benefit from its position of authority so as to deter it from breaking contracts with a national group of investors.

When exercised alongside exit, voice can be a cheap and effective option for foreign firms to recoup contract sanctity. As Hirschman expressed it, 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 voice requires an interested group of actors that has the capacity to lobby through direct or collective action.<sup>188</sup> As argued above, when one firm's contract is threatened, co-national firms are more likely to interpret their contracts as simultaneously threatened. As a result, co-national firms have a greater

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<sup>187</sup> Interviews.

<sup>188</sup> Hirschman 1970.

willingness to protest against each other's broken contracts than do firms of different nationalities that do not perceive their interests as equally endangered. Co-national firms also share special access to resources to exercise voice, such as preexisting ties to co-national firms that can help to overcome collective action problems in organizing lobbying campaigns. Above all, co-national firms have unique access to their diplomats. With these resources, co-national firms can make explicit the tie between the host government's encroachment on contracts and diverted investments, and co-national firms and diplomats can also link investor contract sanctity to other issues in the home-host relationship.

The empirical record shows that co-national actors regularly draw on diplomatic support as well as co-national investor groups to respond to threats to contract sanctity. For example, in 2009, Chinese policymakers took an American 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.<sup>189</sup> In Ukraine, a Western European manufacturer drew on embassy support as well as groups of co-national foreign firms to deter proposed legislation that would discriminate against its international trademarks. While the legislation was industry-specific, diplomats and co-national firms advocated against the legislation for fear of the integrity of their marketing campaigns in Ukraine more generally. Industry-based lobbying across nationalities, in contrast, was weak and ineffective.<sup>190</sup> In the words of an Argentine official, who has interacted with many foreign firms of different nationalities after the Argentine government broke a number of

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<sup>189</sup> Interview, American firm, Washington, D.C.

<sup>190</sup> Interview, Ukraine. Nationality suppressed on request.

contracts in 2001 to 2002, “Foreign investor associations like the American Chamber of Commerce fight, but they fight their own fights.”<sup>191</sup>

While “gunboats” no longer come to the rescue of foreign firms facing broken contracts, if they ever did,<sup>192</sup> members of the local diplomatic staff or even the home government proper do serve as foreign firms’ advocates with the host government. Should a contract dispute arise, gaining the support of commercial attachés, ambassadors, and home country politicians allows foreign firms to capitalize on their home government’s clout with host government decision-makers. Home country diplomats can link firms’ contract sanctity to other issues in the bilateral relationship, meaning that breach of contract will incur additional costs beyond the loss of access to private capital from that national group.<sup>193</sup> For example, since the 1990s home governments have linked threats to their nationals’ contracts to institutions that facilitate bilateral trade, foreign aid distribution, and security concerns, as well as the broader potential for future bilateral cooperation.<sup>194</sup> With diplomatic involvement, the future costs of lost capital access are compounded by the costs of declining bilateral relations. 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.<sup>195</sup> Home governments that push for better treatment in response to threats to their nationals’ contract sanctity today can

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<sup>191</sup> Interview, Germany.

<sup>192</sup> Tomz 2007, Lipson 1985, Wells and Ahmad 2007, but see Mitchener and Weidenmier 2005.

<sup>193</sup> Oye (1992) called this kind of issue linkage “bracketing” – when diplomats make threats that inaction on one issue will trigger punishments in another issue area.

<sup>194</sup> Wells and Ahmad 2007. See case studies in chapters 5 and 6 for contemporary examples. Historically, the “Hickenlooper Amendment” to the Foreign Assistance Act of 1962 legislated that the US government would suspend foreign aid to countries that expropriate American property without just compensation, though formal sanctions were applied only once in Ceylon and it was repealed in 1972. Lipson 1985: 214.

<sup>195</sup> Embassies “make a foreign investment relationship visible, so it is known something will be a problem.” Interview, United Nations sub-group, Moldova.

also save resources that would otherwise have been spent on their nationals' future contract disputes.<sup>196</sup>

Under what conditions can co-national firms access diplomatic advocacy around their contract disputes? Some firms carry enough influence in their home countries to get more reliable access to diplomatic resources than others. Any one firm's problem, however, need not constitute a diplomatic priority. Co-national firms' ability to come together and lobby the home government for support is thus an important determinant of diplomatic involvement. 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. With shared interests in improving their contract sanctity in response to a co-national's broken contract, firms of the same nationality have a foundation upon which to organize collective action, framing breach as evidence of nationality-based discrimination. Co-national firms' previous organizational ties help to make collective lobbying of the home government easier, as they can take advantage of nationality-tied investor associations and inter-firm networks. Co-national firm pressure on home governments may also be successful without explicit collective action, as firms' individual appeals can incorporate aggregate rhetoric to have the appearance of aggregate efforts.

Co-national firms' prominence and organizational ties in the host economy also help them lobby the host government either alongside or in lieu of home country diplomatic support. Foreign firms are often highly visible players in emerging economies, which, combined with lobbying experience from their home countries, can make them influential

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<sup>196</sup> Home governments might also derive domestic benefits, such as campaign contributions, from coming to the aid of its investors' abroad.

in emerging economies' sometimes underdeveloped lobbying environments. Although they are not constituents of the host government, foreign firms' control over existing and future capital access can give them direct leverage over host country decision-makers. A key means by which firms can increase their lobbying leverage is by augmenting their own voice with that of others. But, for firms of different nationalities, activism on behalf of another's contract dispute could draw undue domestic political attention and counterproductively generate new risks to their contract sanctity.<sup>197</sup> Only firms with strong, shared threats to contract sanctity, like co-nationals, are likely participants in collective lobbying of the host government around broken contracts. Like most participants in collective action, co-national firms have incentives to free ride on others' efforts, but collective lobbying of the host government can mirror efforts aimed at the home government by piggybacking on nationality-tied associations.<sup>198</sup> Such associations have already solved the collective action problem, and by advocating for contract sanctity through them, firms further benefit from the direct relationships with host government officials that such organizations often cultivate.<sup>199</sup>

Incentivizing home country diplomats or co-national firms to participate in collective action depends, fundamentally, on the likelihood that collective action will be successful. As the next section argues, the exercise of voice from one group of national actors is a stronger deterrent when there are fewer other national groups to which a government can turn for current and future FDI. When only one investor group is present, diplomatic pressure and foreign investor lobbying is particularly resonant with a host

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<sup>197</sup> Interviews, various, Ukraine, Moldova, and Romania.

<sup>198</sup> Olson 1965.

<sup>199</sup> Ibid.

government. When other national groups have FDI in the host country, however, the deterrent effect of co-national voice is muffled. Given this expectation, diplomats and co-national firms have fewer incentives to take a public stand against breach when foreign firm nationalities are more diverse. Better to deal with increased risks to contract sanctity through other means than demonstrate that the national group's voice is insufficient to sway government officials. The diplomatic and co-national firm exercise of voice is thus less likely when diversity among foreign firm nationalities in a host country is high.

*H2: Firms and diplomats with common national origins are more likely to exercise voice protesting a government breach of contract with a co-national firm than otherwise.*

*H2.1: Co-national voice is less likely to be present and effective when the nationality diversity of the foreign investor community is high.*

## **FDI nationality mix**

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 diplomatic pressure and co-national protest to deter breach. When considered at the level of the host economy as a whole, these expectations of individual firm behavior have counterintuitive implications. Foreign firms' reactions to breach with any given firm are not uniformly costly to the host government, but, rather, costliness is conditioned on the nationality of the targeted firm. 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. In fact, firms of other nationalities may gain competitive advantages as the targeted nationality's exit opens up previously unavailable resources and market share. The more national



groups of firms that present alternative sources of current and future FDI to the host country, the less any one nationality's costly response will constrain the host country's overall access to foreign capital. The costs host governments face when breaching contracts with foreign firms thus depend on the mix of investor nationalities present in the host country.<sup>200</sup>

The nationality diversity of the investor community in a host country, or its *FDI nationality mix*, 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.<sup>201</sup> 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 it 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 the FDI nationality mix 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 compensate for lost capital were it to breach with either group. 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 and breach in the economy overall. Because risks to contract sanctity are overwhelmingly

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<sup>200</sup> This argument is predicated on the assumption that host governments are interested in hosting FDI. In an era of liberalized capital flows, this is true of all but the most isolated and extreme regimes.

<sup>201</sup> In quantitative analysis, I use:  $FDI \text{ nationality mix} = 1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  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. See chapter 4 for details.

bilateral, breach with the second, smaller national group is not a substitute for breach with the large group. In fact, the likelihood of breach is 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. For example, as discussed in the next section, host governments are sometimes motivated to breach to supplement their budgets or for populist reasons, neither of which are best accomplished through breach with a small, non-prominent national group. All else equal, the more even the distribution of FDI across national groups, or the higher the FDI nationality mix, the higher the likelihood of government breach of contract.

While the composition of a host country's set of foreign firm nationalities suggests changed aggregate risk levels, the level of the FDI nationality mix does not in itself suggest which firms or contracts may be targeted for breach. The bilateral determinants of contract sanctity laid out above, including historical ties, legal structure, and nationality-specific business strategies, are not predicated on the size of the nationality's share of FDI. Instead, the FDI nationality mix captures the phenomenon that foreign firms in aggregate are more vulnerable when the host government has more substitute sources of current and future foreign capital.

The FDI nationality mix varies over time as FDI from different national groups enters or exits the economy, for any of the many reasons that foreign firms choose to invest where they do. A rich literature in political science, business, and economics has explored the determinants of FDI, including regime type, policy stability, membership in

international organizations, and partisanship;<sup>202</sup> management strategies, risk tolerance, business networks abroad, and intra-firm considerations;<sup>203</sup> macroeconomic health, market size, resource endowment, and geographic distance. Those nationalities with firms in booming industries are likely to grow to represent bigger shares of a host country's FDI. Nationalities with firms that can exploit a host country's natural resources are also likely to grow their share of total FDI, as are nationalities with more market-seeking firms.<sup>204</sup> In short, the FDI nationality mix comes about and can change considerably with a change in circumstances unrelated to nationality *per se*. This is because one cannot reasonably expect the kinds of firms responding to the many different determinants of FDI to be evenly distributed across national groups.

Figure 1 provides two examples of the FDI nationality mix, in Morocco and Kenya, using measures based on FDI stock originating from OECD countries.<sup>205</sup> In Morocco, the nationality diversity of the investor community began high and trended downwards over the 1990s and 2000s, while in Kenya, it grew from an initially low level to surpass diversity in Morocco. Morocco's proximity to the European Union has made it host to a variety of European firm nationalities. FDI from Germany, the Netherlands, Portugal, Italy, and other home countries entered early and remained relatively stable over the period, though occasional entry and exit contributed to dips and spikes in the FDI nationality mix. Spanish firms became major players in Morocco's tourism and real estate sectors, making them Morocco's second biggest source of FDI. Nonetheless, FDI from France, which occurs in

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<sup>202</sup> E.g., Jensen 2003, 2006; Li and Resnick 2003, Henisz 2002 [2010], Busse and Hefeker 2007, Buethel and Milner 2008, Pinto and Pinto 2008.

<sup>203</sup> E.g., Dunning 1980.

<sup>204</sup> Katzenstein 1985.

<sup>205</sup> For calculation, see chapter 4.

sectors across the economy, was four times greater than Spanish-origin FDI by 2008. The quick growth of French FDI against a backdrop of more stable FDI from other OECD home countries explains the decreasing FDI nationality mix in Morocco in the mid-2000s. Kenya's situation is different. The new entry of FDI from the Netherlands, particularly into cut flowers and horticulture, helps to explain the spike in Kenya's FDI nationality mix in 1999, but Dutch-origin FDI stock subsequently declined. Instead, FDI from the United Kingdom, the United States, and Switzerland, in tourism, banking, light manufacturing, and horticulture, outpaced other national groups in the 2000s and was responsible for pushing FDI nationality mix upward as increases were relatively evenly distributed across these national groups. A decline in the diversity of the investor community in Morocco and an increase in diversity in Kenya occurred despite the fact that Morocco's FDI stock grew by a factor of ten from 1993 to 2008, while Kenya's FDI stock grew only by a factor of three.<sup>206</sup>

One possible concern for the theory would be if the nationality diversity of the investor community had a direct influence on foreign firms' decision-making. If so, a more nationally diverse investor community would deter new entry and reinvestment, for firms would be wary of entering such an environment that would enable threats to contract sanctity. However, such a relationship in fact generates the opposite prediction to that described here. If foreign firms were indeed deterred from entering countries with highly nationally diverse investor communities, the result would be that national investor groups would exit and/or shrink. Thus, the FDI nationality mix would decrease as remaining groups became more concentrated (or, in the case of equal exit across all national investor

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<sup>206</sup> UNCTADStat ([unctadstat.org](http://unctadstat.org)), US State Department Background Notes for Morocco and Kenya, various years.

groups, the FDI nationality mix would remain constant). The implication would be that higher expectations of political risks would be associated with a lower (or constant) FDI nationality mix. The quantitative evidence in this dissertation goes to show that, in contrast, the relationship between high risks to contract sanctity and a high FDI nationality mix is robust (see chapter 4).

Moreover, what we know about how firms make investment decisions suggests that it is very unlikely that the mix of nationalities in a host country *per se* plays a role in FDI exit or entry. Foreign firms are profit seeking, and exit (or non-investment) is an expensive last resort.<sup>207</sup> We know that firms engage in FDI when they seek new markets, more competitive inputs, new access to resources, and more, so there is reason to believe that firms face and respond to incentives to invest even in countries where the FDI nationality mix is high or rising. *Prima facie*, firms willing to invest in emerging economies have some positive level of risk tolerance. A risk-tolerant firm will expend more resources on tools, ranging from corporate social responsibility activities, to political risk insurance, to bodyguards, to compensate for expected risks to contract sanctity up to the tipping point at which the success of an investment is not perceived as possible.<sup>208</sup> With a range of incentives to invest in a given location, and tools to account for expected political risks, there is strong reason for firms to believe *ex ante* that investment makes sense even in countries where the FDI nationality mix is high or rising.

It is true that, according to the theory, firms would be better off predicating their original and ongoing investment decisions not only on today's FDI nationality mix but also

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<sup>207</sup> Exit is expensive for foreign direct investors as compared to investors in other capital flows. Mosley and Singer 2008.

<sup>208</sup> Investor political risk management strategies can create moral hazard for host governments if investors' precautions mitigate the loss of capital that might otherwise follow breach.

on the trajectory of that mix. However, firms do not reasonably have the capacity to estimate future trends in the FDI nationality mix. Accurate predictions would require iterated estimates of all current and entering individual firms' investment decisions, aggregated by national group, and then combined into an economy-wide measure. To make up for this inability, firms have incentives to pay attention at least to the dynamics of their position in the FDI nationality mix over time; the case studies in chapters 5 and 6 provide evidence of this behavior.

While the entry or exit of a large foreign firm of a given nationality could influence the FDI nationality mix, no one investor has total control over the current and future distribution of FDI across national investor groups. Even if one firm's large investment shapes the trend in overall FDI stock, its decision need not be representative of the investment decisions made by firms from a variety of other home countries. An emerging economy government does not have the ready ability to control the trajectory of its FDI nationality mix, either. Host governments can impose sanctions on investors of certain nationalities, and most BITs allow host governments some latitude to discriminate against foreign firms before they enter the country. These exceptions aside, host economies operating in an era of liberalized capital flows are open to national groups of all types. Emerging economy host governments sometimes target certain national groups as investors, usually through FDI promotion agencies, but their record of success has been spotty at best.<sup>209</sup> Rather, governments host whatever FDI nationality mix emerges as a result of the many determinants of FDI. Thus, a key variable that shapes firms' vulnerability

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<sup>209</sup> Interview, European Union consultant for Investment Promotion Agencies.

to government breach of contract is largely exogenous to both the actions of individual foreign firms and host governments.

Under economic globalization, the expectation has been that foreign firms in large part enforce their own contracts, because FDI diversion follows from contract breach. By starting from the effects of contract breach at the level of the firm, and aggregating to the level of the economy as a whole, I have argued that FDI contracts with host governments are not always self-enforcing. A breach leads only those firms that perceive risks to their contract sanctity as similar to those of the targeted firm to act in ways costly to the host government, through both exit and voice. Foreign firms of the same national origins share risks and resources that make their response to co-national breach punitive, particularly so when their actions have a greater influence on the host government's access to capital when the FDI nationality mix is low.<sup>210</sup> When an increasingly diverse set of foreign firms is present in a host country, however, the government gains more space to breach contracts with one national group without threatening the contract sanctity of other groups.

*H3: The greater the nationality diversity in a host country's foreign investor community, the higher the likelihood of government breach of contract.*

## **Host government motives and prospects for deterrence**

Given variation in the costs host governments face from foreign firms when considering contract breach, what can be said about the benefits that motivate host governments to break contracts? The basic intuition in this dissertation is that the motives behind breach are countless. For convenience, this dissertation often refers to a "host

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<sup>210</sup> Lipson anticipated this argument: "The lack of diversity in Latin American economic relations, which is simply another index of US dominance, ensured that anti-expropriation sanctions would be severe because they were coherent." Lipson 1985: 111.

government” as a singular entity. However, host governments are not unitary actors, and internal politics contributes to decision-making around contract sanctity. Host governments and their constituent parts are interested in remaining in office and otherwise deriving benefits from their positions of authority, and breach of contract with foreign firms can sometimes aid government actors in these goals. Breach has been and continues to be a means for government actors to capitalize on changed circumstances despite preexisting commitments, as it can be for any counterparty. The constancy of temptations to breach, whether we speak of apartment leases or privatization contracts with foreign investors, means we need to focus not on variation in the benefits but rather variation in the constraints that international capital places on breach. Since international capital liberalization in the 1980s, the opportunity costs of foregoing foreign capital altogether have become too high for all but the most isolationist regimes. In fact, in the period since 1990, breach has only rarely been about a rejection of foreign ownership *per se* (see chapter 2). Nevertheless, this section goes to substantiate the proposition that the motives behind breach are many, even when governments share a basic interest in accessing foreign capital.

Corruption is one means by which government officials can use breach to benefit from their authority. But breach of contract has since 1990 been a means of achieving political and policy goals beyond corruption: breach has supplemented government budgets; served as a means of re-regulation; generated partisan populist and economic nationalist support; and been wielded as a foreign policy tool. While this dissertation defaults to describing host governments as unitary actors, the benefits from breach may in fact be unevenly distributed across political parties, bureaucracies, or other actors in 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 in the case studies in chapters 5 and 6, the divisions created by these asymmetries can provide leverage for co-national foreign firms and their advocates to sometimes deter breach of contract.

Some governments have used breach of contract with foreign firms as a means to get cash, whether to supplement budgets in hard times or respond to fairness issues in good times. Foreign firms are often the wealthiest firms in an emerging economy, with parent company resources on which to draw. As they are not part of a government's constituency, infringing on their operations need not bring direct challenges to a government's authority. Breach in the form of withholding payments or unlawfully increasing a foreign firm's tax burden can provide a third budgeting option apart from cutting spending or raising taxes from domestic actors. Argentina broke its commitments to a number of foreign firms in the context of its 2001 to 2002 economic crisis, resulting in a spate of international investment arbitrations brought against the government. Argentina's defense in these suits has been that of necessity: because breach allowed the government to expropriate investor earnings and save outlays, it prevented what would have been a worse fiscal crisis. Whatever the legality of the Argentinian government's actions, prioritizing domestic financial health over the protection of foreign investor property served its short-term domestic interests while, from the point of view of foreign firms, breaking contracts. In another example, 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 in the domestic political economy. Breach has also been a means for host governments to address fairness issues in times of economic growth and budgetary plenty. Economic nationalism and beliefs about the sovereign right of a host country to profit from its natural resources have spurred dissatisfaction with the fairness of foreign contracts in oil and gas and mining. Governments in Venezuela, Ecuador, Kazakhstan, the Democratic Republic of Congo, Mongolia, and elsewhere have forced renegotiation of contracts or wholly expropriated foreign-owned assets in these industries.

One component of government breach of contract is sometimes called “regulatory taking,” when a government’s extra-contractual devaluing of foreign property accomplishes what amounts to a 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. In a controversial IIA brought under the investor protection portion of the North American Free Trade Agreement (NAFTA), an American firm successfully argued that changed Mexican regulations on hazardous waste disposal unlawfully prevented the American firm from operating.<sup>211</sup> In Uruguay, American firms have filed suit under BIT protections in response to legislation enacting some of the world’s most stringent tobacco packaging and branding laws, arguing that the legislation devalues their intellectual property in favor of lesser-recognized local brands.<sup>212</sup> The World Health Organization, for its part, supports Uruguay, demonstrating that multilateral organizations

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<sup>211</sup> *ARB(AF)/91/1 Metalclad Corporation v. United Mexican States*. Brought in 1997; award rendered in 2000.

<sup>212</sup> E.g., *ARB/10/7 Philip Morris Brand v. Oriental Republic of Uruguay*. Brought in 2010.

are not always on the side of foreign firms in contract disputes.<sup>213</sup> Chapter 6 presents a case in Romania in which local and international environmental groups laud the government's effective expropriation of a Canadian gold mine, an action that has received the unofficial approval of the European Union.<sup>214</sup> In these situations, governments – sometimes with the backing of international actors – have used what foreign firms consider to be breach of contract to change regulatory standards.

Breach of contract that helps to achieve policy goals can earn a host government, or certain parties within it, political rewards. In Slovakia, the party in power from 2006 to 2010 used the threat of breach to garner populist support. In 2006, the government threatened an Italian electricity producer with expropriation, accusing it of overcharging its Slovakian customers; in 2008, the government threatened the German and French owners of the national natural gas monopoly with renationalization if it 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 market actors.<sup>215</sup> In the end, the Slovakian government gained foreign firms' cooperation over energy price controls – and got reelected – without following through on expropriation threats.<sup>216</sup> In Ukraine after the 2004 Orange Revolution, one party in the coalition government advocated the nationalization and reprivatization of unspecified privatized assets, which threatened the property of foreign firms across the economy.<sup>217</sup> This

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<sup>213</sup> See, for example: Wilson, Duff. "Cigarette Giants in Global Fight on Tighter Rules." *The New York Times*: 13 November 2010.

<sup>214</sup> See, for example: "In Transylvanian town, gold pits protectors of heritage against developers promising riches." *The Washington Post*: 21 August 2011.

<sup>215</sup> Malov and Ucen 2009.

<sup>216</sup> Consistent with the hypotheses offered here, FDI nationality mix increased steadily in Slovakia over this period.

<sup>217</sup> Aslund, Anders. "Betraying a Revolution," *The Washington Post*: 18 May 2005.

campaign, which was supported by an overwhelming majority of Ukrainian citizens, buoyed the party leader's standing.<sup>218</sup> These partisan rewards vanished, however, once the costs of breach proved too high and the coalition partner canceled the campaign – and ousted the party from government (see chapter 5).<sup>219</sup>

The bilateral determinants of contract risks described above can also shape the domestic benefits host governments reap from breach. For example, just as home country diplomats can link other bilateral issues to an incidence of breach of contract, so too can host governments. 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 company Yukos, a transaction that the Russian state had authorized 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, which from the Russian firm's and the Russian government's point of view resulted in rightful Russian assets being 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 also buoyed domestic support for the Lithuanian government, and it was viewed positively by the European Union.<sup>220</sup>

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<sup>218</sup> Wellhausen 2010. A poll in Ukraine, by the Kyiv International Institute of Sociology, found in May 2005 that 71.3% of Ukrainians supported the government's plan, with 81.8% support in Kyiv and Central Ukraine. "Poll: 71.3% of Ukrainians back privatization." Interfax News Service: 14 May 2005.

<sup>219</sup> For further discussion, see chapter 5.

<sup>220</sup> 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.

A common refrain in contract disputes is that the dispute itself is the foreign firm'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 dissertation is based on foreign firms' understanding of government actions that violate the value of their property rights. 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, prompting co-national FDI exit and voice. As demonstrated in chapter 4, when foreign firms publicly sue host governments, the host economy foregoes FDI from firms of that nationality well before a decision is rendered in a sometimes years-long legal process.<sup>221</sup> Whatever the legality of any particular breach, the costs of co-national firms responding adversely to breach can, under the right conditions, deter host governments from undertaking what foreign firms see as breach of contract.

## **Conclusion**

The argument that the nationality of foreign firms matters at all runs counter to the conventional wisdom. Indeed, the claim that multinational corporations have no nationality

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<sup>221</sup> See chapter 4. Allee and Peinhardt 2011 find that countries sued at the main international investment arbitration tribunal lose out on aggregate future FDI when cases are initiated, pending, settled, or lost.

is a common one. In 2008, *The Economist* published a special report on the “stateless multinational,” writing that “truly global” firms are the next phase in the evolution of the multinational corporation.<sup>222</sup> One scholar hypothesizes that we are now in a “borderless world,” and another makes the case for “the coming irrelevance of corporate nationality.”<sup>223</sup> Some executives certainly share this understanding of the “stateless multinational.” In an interview at a multinational firm in Ukraine, the local director said, “We are technically British, people think we’re American, and I’m Australian...but what does it matter anyway?”<sup>224</sup> In this view, country of origin might matter at extreme moments, such as when firms are looking for bailouts from their home governments. But as far as multinational firms’ activities abroad are concerned, country of origin is thought to be beside the point.

In contrast, the theory offered here takes seriously the bilateral relationship that is embedded in each foreign investment transaction. The sanctity of contracts that firms enter into with governments draws on the nationality of both the host country and the firm. 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.

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

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<sup>222</sup> “In praise of the stateless multinational.” *The Economist*: 18 September 2008.

<sup>223</sup> Ohmae 1990.

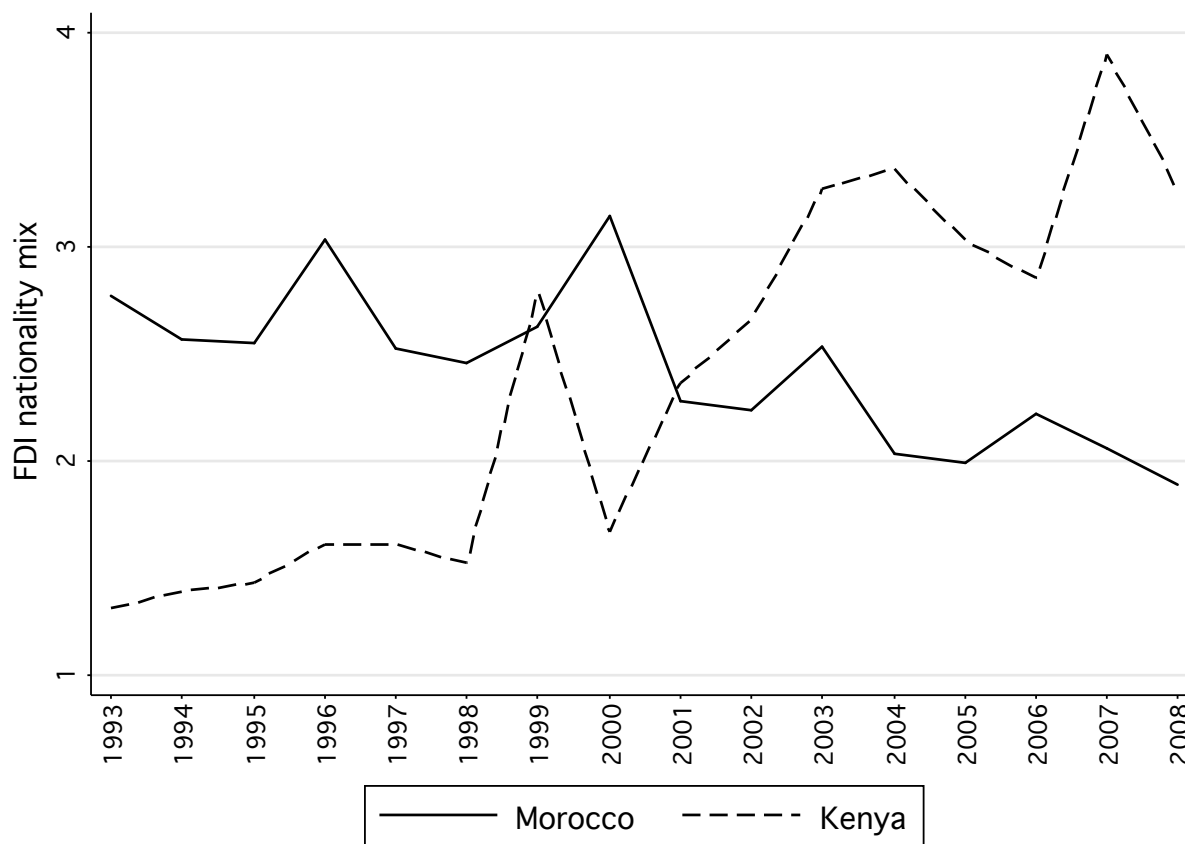
<sup>224</sup> Interview, British firm in manufacturing, Ukraine. Another firm in the same industry in Ukraine had recently faced a broken contract; this executive scoffed at the idea of joining efforts along industry lines.

less likely to motivate the other to exit or exercise voice. 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 more diverse firm nationalities makes foreign firms less effective at enforcing their own contracts and, as a result, increases the likelihood of government breach of contract.

Taking exposure to more bilateral FDI relationships as an indicator of economic integration, the theory laid out here challenges the conventional wisdom that the development of private property rights protections moves together with economic globalization. It has gone almost without saying that a government interested in accessing global capital must commit to its own contracts entered into with foreign firms. But because foreign firms do not uniformly act in ways costly to host governments that break contracts with foreign firms, foreign firms do not always compel governments to preserve foreign firms' property rights. Instead, nationality diversity can be a liability to firms and an opportunity for host governments to exercise autonomy even in an economically globalized world.

## Figures

**Figure 1. FDI nationality mix in Morocco and Kenya (1993-2008)**



FDI nationality mix<sub>t</sub> =  $1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ .

Source: Organization for Economic Cooperation and Development (OECD), FDI positions abroad.



## Chapter 4: Quantitative Tests

In this chapter, I conduct quantitative tests of one of the proposed causal mechanisms underlying the positive relationship between the FDI nationality mix and the likelihood of government breach of contract, as well as tests of the relationship at the level of the economy as a whole. First, I use bilateral FDI flows from OECD countries to emerging economies as the means to test the hypothesis that firms are more likely to exit or divert FDI following breach of contract with a co-national firm. I operationalize breach as the incidence of public international investment arbitrations (IIAs) brought by foreign investors against host governments. The panel covers 1987 to 2008. I find that bilateral FDI flows are significantly lower when co-national firms have brought IIAs in the previous one, two, or five years. In contrast, bilateral FDI flows are unaffected by IIAs brought by firms of other national origins. These results provide evidence that co-national firms are responsible for capital flight after co-national breach, sharpening our understanding of the mechanism by which FDI exit imposes constraints on government breach of contract.

This differential drawdown by co-national firms is a key causal mechanism that contributes to the expected positive relationship between the FDI nationality mix and the likelihood of government breach of contract. I use panel data from 1986 to 2008 to test the hypothesis that a higher FDI nationality mix increases the likelihood of government breach of contract in the economy as a whole. I measure the likelihood of contract breach in several ways, including several measures of investor beliefs about breach of contract; political risk insurance pricing; and the incidence of public IIAs brought by foreign investors against host governments. I operationalize the FDI nationality mix by using a Hirschman-Herfindahl Index of the mix of OECD-origin FDI by host country-year. Results

are consistent across multiple measures of the dependent variable and the explanatory variable of interest: a greater diversity of firms' national origins is associated with a greater likelihood of government breach of contract. Thus, the results in this chapter provide strong evidence that host governments have more space to breach contracts when FDI nationalities are especially mixed, and one reason why is because firms are more likely to predicate their investment decisions on co-national firms' broken contracts.

### **Dyadic tests of the mechanism: Differential FDI drawdown**

In this section, I provide evidence on the hypothesized dyadic causal mechanism operating at the level of the firm, which will ultimately help to account for the economy-wide association between diverse foreign firms and government breach of contract. I test the hypothesis that firms are more likely to draw down or divert investments following breach with co-national firms, while investors of other nationalities are unlikely to change their investments in response. My tests take advantage of the filings of public IIAs by foreign investors against national governments as the explanatory variable of interest.

As described in chapter 2, foreign investors have brought public IIAs in a variety of industries against the vast majority of emerging economy governments. The data used here include 280 public<sup>225</sup> IIAs from 1998 to 2008, as collected by the United Nations Conference on Trade and Development (UNCTAD).<sup>226</sup> These include IIAs from 31 different

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<sup>225</sup> Firms and/or governments sometimes choose to keep IIAs private, arbitrating them in confidential settings like the London Court of International Arbitration or the International Commercial Court. These private arbitrations have no power to signal breach of contract to other foreign firms (co-national or otherwise) and are rightfully excluded from the analysis.

<sup>226</sup> UNCTAD data, as opposed to ICSID-only data, comes closer to capturing the population of public IIAs in this period. We can reasonably assume that UNCTAD's data is missing "as if at random," particularly as country fixed effects employed in the estimation model mean that our randomness assumption is focused on missing data within countries over time.

OECD home countries, and 59 different host countries are respondents.<sup>227</sup> The industries covered by these IIAs include oil and gas, utilities, banking, services, transportation, manufacturing, agriculture, telecommunications, real estate, and media. One example of an IIA included in the dataset is the 2007 suit in which an Austrian firm sued Ukraine for reneging on contracts concerning the construction of a hotel. The Austrian firm was ultimately awarded US\$5.2 million in 2010. Also included in the dataset are 44 public IIAs brought against Argentina from 2002 to 2008. In these suits, investors of several different nationalities claim damages as a result of currency inconvertibility and government non-payment following the government's devaluation of the peso, in the midst of economic crisis. Some suits are ongoing, but Argentina is late in paying over US\$300 million in damages to American investors as of 2012.<sup>228</sup>

The analysis here uses the filing of public IIAs as an explanatory variable of interest, to capture the incidence of a government breach of contract with firms of a certain nationality. At the time of filing a public IIA, fault over breach of contract has not yet been legally assigned. However, filing alone is a sufficient indicator that the foreign firm(s) involved perceive a breach of contract. Obviously, there is a strategy on the part of the firm (and its lawyers) in bringing a case to a public IIA. But filing a public IIA is a costly action: a foreign firm spends resources to bring a lawsuit; resolution often takes years; and the investor forgoes its goodwill with the government, casting doubt on the ability of that firm to successfully invest in the host country again in the future. In a study of publicly available IIA awards made between 1990 and 2006, Frank finds that the average award was US\$10

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<sup>227</sup> See Appendix 1A for the list of countries used. The data also include a small number of suits brought by non-OECD countries.

<sup>228</sup> See chapter 1.

million or just a fraction of the average request of US\$343 million.<sup>229</sup> Further, foreign investors do not always win. Of the IIAs included here that have reached an outcome, many have been thrown out on jurisdictional grounds or other legalities, while in some cases arbitrators have ruled in favor of the host government.<sup>230</sup> Uncertainty around the outcome of a public IIA underscores the notion that arbitration is a costly option of last resort for foreign firms.

Whatever the legal outcome of a particular public IIA, a filing signals that a foreign firm publicly accuses the host government of breach of contract. Foreign firms make their claims in the context of codified, international law. Moreover, the host government is committed enough to its contrary position to let the suit go forward in public, rather than settle out of court.<sup>231</sup> If there is any moment at which other foreign firms would take notice and react in ways costly to the host government, this is it. Allee and Peinhardt find, in fact, that host countries that have been sued in public IIAs – regardless of outcome – receive fewer future FDI inflows.<sup>232</sup> The hypothesis tested here goes a step further: FDI flows in a directed dyad should be lower following a co-national public IIA, whereas public IIAs filed by investors of other nationalities should have no effect on FDI flows in a directed dyad.

Equation (1) specifies the estimation model:

$$(\text{Net FDI inflow})_{ijt} = \delta_1 IIA_{i,j,t-1} + \delta_2 (\text{Other IIA})_{j,t-1} + \beta_1 \mathbf{X}_{j,t-1} + \beta_2 \mathbf{X}_{i,t-1} + \beta_3 \mathbf{X}_{ij,t-1} + \gamma_{ij} + \tau_t + \varepsilon_{ijt} \quad (1)$$

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<sup>229</sup> Franck 2009: 447. Of course, this excludes private settlements that sometimes lead foreign investors to withdraw claims.

<sup>230</sup> Frank (2009) finds that development status does not significantly determine outcome, nor does the nationality of the presiding arbitrator. There are no appeals in international investment arbitration; annulments are based on facts of law and not the content of cases. See also: Van Harten 2005.

<sup>231</sup> Elkins et al 2006, Bebchuk 1984.

<sup>232</sup> Allee and Peinhardt 2011.

The dependent variable is logged net FDI flows from OECD country  $i$  to emerging economy host country  $j$  in year  $t$ .<sup>233</sup> Net FDI inflows are appropriate, as I expect both current and potential co-national firms to reconsider investments following evidence of nationality-tied risks to contract sanctity. I follow the literature in adding a constant value to the data large enough to shift negative values to positive values; this allows me to log-transform the dependent variable without losing observations that indicate net FDI divestment.<sup>234</sup> The third, fourth, and fifth terms of Equation (2) are lagged time-varying host, home, and dyad controls;  $\gamma_{ij}$  and  $\tau_t$  are dyad and year fixed effects. Standard errors are robust and clustered by dyad to account for serial correlation.<sup>235</sup> The panel covers 1998 to 2008, a period in which investors brought 280 public IIAs out of some 360 recorded as of 2011.

The first independent variable of interest,  $IIA_{ij,t-1}$ , is a dummy of public IIA(s) filed by firms from home country  $i$  against host country  $j$  in year  $t-1$ .<sup>236</sup> The expectation is that firms from home country  $i$  are disproportionately responsible for FDI diversion in response to their own IIA(s); thus, the sign on  $\delta_1$  is hypothesized to be negative. The second independent variable of interest,  $(Other\ IIA)_{j,t-1}$ , is a dummy of public IIA(s) brought by nationals of other home countries against host country  $j$  in year  $t-1$ . IIA(s) brought by firms that are not co-nationals are not expected to differentially affect FDI inflows in the directed dyad; thus,  $\delta_2$  is hypothesized to be insignificant. In Model (2), dummies indicate IIA(s) filed

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<sup>233</sup> Limiting the data to developed-emerging dyads excludes observations where developed countries have been sued in IIAs, which mainly includes NAFTA suits against the United States and Canada. Such countries are not expected to face the same pressures to adhere to foreign firm property rights in order to secure capital access.

<sup>234</sup> Li and Vashchilko 2010.

<sup>235</sup> Zeger and Liang 1986.

<sup>236</sup> Co-nationality is assigned based on the BIT under which an IIA is registered. When IIAs are brought under a multilateral instrument, the country of residency of the claimant is used as the claimant's nationality.

in the previous two years; the dummies in Model (3) indicate if IIA(s) have been filed in the previous five years.

I account for several time-varying characteristics of the host country, home country, and directed dyad. I control for the cumulative number of *BITs*, as Kerner finds that BITs have an effect on aggregate FDI, regardless of with whom they are signed.<sup>237</sup> As before, I account for political and institutional determinants of FDI using *political constraints*.<sup>238</sup> I use *risks to property rights* to control for the effects that expectations about (and not the incidence of) adverse government actions have on FDI. This variable is an index of investor expectations about risks to contract viability, profit repatriation, and timely payments taken from the Political Risk Services International Country Risk Guide (ICRG).<sup>239</sup> Following standard analyses of FDI flows, I control for the host country's attractiveness as an investment destination with *host GDP per capita (logged)*, *host GDP growth*, *population (logged)*, and *capital account openness*.<sup>240</sup> Macroeconomic trends in the home country likely have an effect on the willingness of firms to invest abroad. I therefore control for *home GDP per capita (logged)* and *home GDP growth*. *Dyadic trade (logged)* accounts for the connection between trade and firms' interests in making direct investments abroad.<sup>241</sup> All independent variables are lagged one year.<sup>242</sup> Additionally, I follow Allee and Peinhardt in including *world FDI flows* to account for the global factors, like changes in business strategy,

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<sup>237</sup> Kerner 2009. I include dyads that do and do not have BITs to address the hypothesis that IIAs brought by other nationalities (usually brought under other dyads' BITs) do not have a significant effect on bilateral FDI.

<sup>238</sup> Henisz 2002 [2010]. Results are robust to using *Regime Type (-10 to 10)* from Polity IV (Marshall, Jaggers, and Gurr).

<sup>239</sup> "A Business Guide to Political Risk for International Decisions: Part II. International Country Risk Guide." *Political Risk Services: 27*. This is also the dependent variable in Model (5). See *Monadic Tests* for more information on the ICRG.

<sup>240</sup> Chinn and Ito 2006.

<sup>241</sup> Trade data are from the IMF Direction of Trade Statistics and the Correlates of War Project Trade Data Set (Barbieri et al 2009).

<sup>242</sup> Questions of endogeneity are mitigated, as it is previous FDI stocks (and not future FDI flows) that would contribute to the incidence of IIAs, which are often the result of years-long disputes.

that have contributed to non-linear increases in FDI.<sup>243</sup> The model includes fixed effects for dyad  $ij$  and year  $t$ , to account for cultural and other time-invariant ties between home and host countries as well as annual trends. Identification is off of within-dyad year-to-year changes.

## Results and robustness

Table 1 reports the regression results. Model (1) presents the basic specification without the IIA variables of interest. In Models (2), (3), and (4), we see that co-national IIAs in previous years have a consistent and significant negative effect on future co-national net FDI inflows. In Model (2), 102 dyads account for positive values of the co-national IIA dummy, in which investors from 16 different home countries brought IIAs against 43 different host countries. The effect size of the negative coefficient is large: the filing of co-national IIA(s) in the previous year decreases net dyadic FDI inflows by, on average, US\$28.3 million. In Model (3), the filing of co-national IIA(s) in the previous two years lowers dyadic FDI inflows by US\$15 million. In Model (4), when IIA(s) are filed in the previous five years, the average effect lowers dyadic FDI inflows by US\$46.8 million. These decreases in dyadic FDI flows are the more impressive given that the sample mean for annual dyadic FDI inflows is just US\$83.2 million. In contrast, the filing of IIA(s) by firms of other nationalities does not have a significant effect on dyadic FDI in any of the specifications, as predicted. In all Models, the coefficients for co-national and other IIA(s) are significantly different (with 95-99% confidence) and their covariance is 0, as implied by the theory.

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<sup>243</sup> Allee and Peinhardt 2011: 419.

The directionality of control variables provides support for the overall model specifications. *Host country GDP per capita*, and *home country GDP growth* are associated with higher dyadic FDI flows. All else equal, *home country GDP per capita* is associated with lower dyadic flows; this captures firms' incentives to stay home when home offers significant market opportunities. *Risks to property rights* is also associated with lower dyadic flows, as expected. Due to data constraints, including either the incidence of dyad *Preferential Trade Agreements (PTAs)* or dyad *militarized inter-state disputes (MIDS)* markedly reduces the sample size; IIA variables are correctly signed but outside of standard levels of significance.<sup>244</sup> Table 1A reports results of estimating the effect of public IIAs on dyadic FDI flows using an Arellano-Bond equation, which provides an alternate method to dealing with possible over-time correlation in the data by using a lagged dependent variable and endogenous instruments instead of year fixed effects. Results here are consistent with the findings of the fixed effects model.

### **Monadic tests: More diversity, more breach**

Having found evidence for the underlying causal mechanism of differential FDI drawdown by co-nationals, I now test the economy-wide hypothesis implied by the theory's firm-level expectations: an increase in the FDI nationality mix increases the overall likelihood of government breach of contract. I use a multivariate regression framework, as specified in Equation (2).

$$Breach_{it} = \beta_1(FDI\ nationality\ mix)_{i,t-1} + \beta_2\mathbf{X}_{i,t-1} + \gamma_i + \tau_t + \varepsilon_{ijt} \quad (2)$$

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<sup>244</sup> Buethe and Milner 2008; Goldstein, Rivers, and Tomz 2007; Ghosn, Palmer, and Bremer 2004.



The coefficient of interest is  $\beta_1$ , which measures the effect of change in *FDI nationality mix* on breach of contract. It is hypothesized to be positive. The matrix  $\mathbf{X}_{it-1}$  contains a set of lagged time-varying controls. The next two terms are country and year fixed effects. Standard errors are robust and clustered by country to account for serial correlation.<sup>245</sup> The panel covers 1990 to 2008.

### **FDI nationality mix**

I use a Herfindahl-Hirschman Index (HHI), originally an indicator of industrial fragmentation, to measure the mix of nationalities present among a host country's foreign investors.<sup>246</sup> High values on *FDI nationality mix* mean that FDI is more evenly spread over more national groups. To calculate the measure, I use OECD data on the annual FDI stock of OECD countries in emerging economies.<sup>247</sup> While OECD data does not capture the growing segment of South-South FDI, omitting FDI originating in other home countries causes me to underestimate the FDI nationality mix.<sup>248</sup> Each OECD nationality's FDI stock is the share of its investment out of the total FDI stock across reporting OECD countries. Values of *FDI nationality mix* can be interpreted as the effective number of OECD nationalities represented in the host country. *FDI nationality mix* is available for 74 emerging economies. It ranges from a value of 1 to 10.6 (Ukraine in 2003), with a sample mean of 2.9 effective

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<sup>245</sup> Zeger and Liang 1986.

<sup>246</sup> For ease of interpretation, I use an inverse HHI. Inverse  $HHI_{it} = 1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ .

<sup>247</sup> Data is available for up to 32 OECD countries. Emerging economies are all countries except OECD members as of 1994, plus Turkey. Negative FDI stock is changed to zero, as this is the appropriate lower bound for measuring the presence of national investor groups.

<sup>248</sup> This is true based on the plausible assumption that a small number of South investors do not account for such a large proportion of host country FDI stock as to overwhelm the distribution of OECD investors. Some empirical confirmation is also available. The correlation between this paper's OECD-based HHI and a world-based HHI (IMF data; available for 2009 only) is 0.636. The OECD-based HHI is greater than the world-based HHI in 63 of 79 countries, and results are robust to dropping those 16 countries.

nationalities per country-year.<sup>249</sup> Figure 2 reports country averages from 1990 to 2008. Out of the available data, Turkey has the highest average value (6.8 effective nationalities).

In the data, assembled by the OECD from OECD-country national statistical offices, FDI country of origin is based on the residence of an economic entity. This means that firms are tied to what is understood to be their home country rather than sites of mere legal incorporation.<sup>250</sup> Even if some amount of FDI is attributed to what one might consider “intermediate home” countries, the OECD-based *FDI nationality mix* provides a strong test of the theory: some if not all of the expectations about the effects of nationality on contract sanctity apply to “intermediate” national groups. For example, the set of investors using an intermediate home country must deal with the negative publicity such a decision can generate; those investors also share access to resources like an intermediate home-host BIT.<sup>251</sup>

Some multinationals have multiple countries of national origin as a result of mergers and acquisitions and the growth of international subsidiaries. Far from being “meta-national,” such firms are made vulnerable to risks associated with more than one bilateral relationship, and they can call on diplomatic and co-national resources from more than one home country. By attributing these firms’ FDI to only one home country, I underestimate the true spread of FDI across national groups and bias *FDI nationality mix* away from supporting the hypothesis. “Round-tripped” firms are a particular subset of

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<sup>249</sup> The variable equals 1 in 7.6 percent of observations, and results are robust to their exclusion.

<sup>250</sup> “The residence of an economic entity is determined on the basis of the economic territory with which it has the strongest connection determined by its predominant center of economic interest.” Glossary of Foreign Direct Investment Terms and Definitions, *OECD Benchmark Definition of Foreign Direct Investment* (Fourth Edition). Statistical units are assumed to have the same ability to identify “true” residence.

<sup>251</sup> The 2004 jurisdiction decision in *Tokios Tokeles v. Ukraine (ICSID Case No. ARB/02/18)* provides the 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.

firms with two nationalities. Round-tripping occurs when host country citizens incorporate firms outside of the host country and then reinvest funds back to the host country.<sup>252</sup> By gaining foreign residency, round-tripped firms can access political risk management strategies otherwise restricted to foreign investors, such as the ability to sue governments under BITs.<sup>253</sup> Unfortunately, even dedicated business analysts are unable to provide good cross-national estimates of round-tripping, especially as the phenomenon overlaps with FDI coming from diaspora investors. Nevertheless, attributing round-tripped firms only to their OECD country of residency underestimates the set of effective national groups by excluding separate categories for domestic/foreign hybrids.

A cross-sectional dataset on bilateral FDI flows in 2009 from all countries to all countries provides empirical support for the prediction that *FDI nationality mix* underestimates true nationality diversity. This data, assembled by the International Monetary Fund (IMF), allows me to calculate the HHI based on FDI originating in both OECD and non-OECD countries. The 2009 world-origin HHI is positively correlated with the 2009 OECD-origin HHI at 0.64, and the OECD-origin HHI is smaller than the world-origin HHI in 63 of 79 countries.<sup>254</sup>

### **Dependent variables**

A worldwide measure of breach of contract is difficult to come by, as only selected contract breaches are elevated beyond interested investors' knowledge to the public record. I thus use several strategies to get at the incidence of breach. The first analyses use

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<sup>252</sup> For example, Chinese capital is extensively round-tripped through Hong Kong; West African investors often use Cape Verde; and Russian and Ukrainian investors often use Cyprus.

<sup>253</sup> See Footnote 250.

<sup>254</sup> 2009 is not included in the analysis due to data constraints on the covariates used as controls. Results robust to excluding those 16 countries in analysis.

measures of foreign investors' expectations of a host government's propensity to breach contracts. In the robustness checks described below, I measure breach with a count of legalized contract breaches as well as with risk ratings that underlie political risk insurance pricing.

Aggregate investor expectations are an appropriate substitute for a well-formed direct measure of breach, as expectations are plausibly grounded in experience with or knowledge about contract breach. I generate three dependent variables from the Political Risk Services International Country Risk Guide (ICRG), a set of indices used by both private and institutional clients to measure "potential risks to international business operations."<sup>255</sup> The ICRG data are based on expert analysis of the overall foreign investment environment in a host country and informed by investor surveys. In Model (5), the dependent variable *Contract Risks* includes expectations about risks to contract viability, profit repatriation, and timely payments, each of which are core components of what this paper identifies as a breach of contract (see Figure 1 for summary by world region). In Model (6), I sum scores on *Contract Risks* and *FDI-related Corruption* in order to capture a government's "tendency to adopt distributive policies and to make opportunistic use of public power."<sup>256</sup> *FDI-related Corruption* includes investor expectations about the willingness of government actors to carry out financial breach (demands for excess payments, exchange controls, etc.) or use political power to deal unfairly with foreign investors (nepotism, job reservations, etc.). In Model (7), I follow the literature in summing *Contract Risks*, *Corruption*, *Bureaucratic Hold-ups* (likelihood of discriminatory operational

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<sup>255</sup> "A Business Guide to Political Risk for International Decisions: Part II. International Country Risk Guide." *Political Risk Services*: 27.

<sup>256</sup> Humphreys and Bates 2005: 412.

changes when governments turn over), and *Law and Order* (judicial impartiality and foreign firm-relevant crime).<sup>257</sup> All variables are transformed so that higher values indicate more risks.

### **Additional covariates**

Two basic control variables are *FDI stock (logged)* and the cumulative number of *BITs* signed by a country. Both FDI stock and BITs approximate the quantity of contracts the host government has made with foreign firms. BITs also facilitate the public IAs through which government breaches of contract are sometimes publicized. Henisz's *political constraints* accounts for arguments about the effects of institutions and policy stability on property rights violations.<sup>258</sup> The ideal control for the effect of industry on government breach of contract would account for the FDI position in obsolescing bargain-prone natural resource industries by country-year. In the absence of robust international data, I construct *natural resource exports* to control for oil, gas, and mineral exports as a percentage of total merchandise exports. This measure is appropriate given the assumption that FDI in natural resources moves together with exports. I use *GDP per capita (logged)* to capture development levels as well as to account for variation in infrastructure investment, also prone to the obsolescing bargain.<sup>259</sup> *GDP growth* controls for the argument that economic downturn may make the short-term domestic benefits of breach more attractive to host governments, no matter the long-term costs. It also controls for the contrary argument that governments have incentives to act opportunistically when times are good

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<sup>257</sup> Allee and Peinhardt 2011, Jakobsen and de Soysa 2006, Li and Resnick 2003. Results are robust to constructing the combined measures with principal components estimation.

<sup>258</sup> Henisz 2002 [2010]. Results are robust to using *Regime Type (-10 to 10)* from Polity IV.

<sup>259</sup> Frieden 1994.

and fairness in distribution becomes a more salient issue.<sup>260</sup> All independent variables are lagged one year.<sup>261</sup>

I include both country and year fixed effects, so that the model identifies off of within-country year-to-year changes in the independent variables. This allows investors' readiness to change their expectations of breach to vary by country; it also allows for worldwide, annual trends in investors' perceptions of host countries' willingness to breach.

## **Results and robustness**

Table 2 reports regression results for Models (5) to (7). In all three Models, *FDI nationality mix* is a positive and significant determinant of increased risks to contract sanctity. Effect sizes are large. For example, the 0.115 increase in the 12-point scale in Model (5) is equivalent to the difference between the high expectations of contract risks in Kuwait in 1990 and the lower expectations of contract risks in Kuwait in 1996, after the First Gulf War. In Model (7), the effect size is equivalent to the difference between the higher expectations of contract risks in Russia in 2004, after prominent foreign-tied oligarchs had been arrested, and the lower expectations of contract risks in Russia in 2007. The positive effects of the FDI nationality mix on investor expectations of breach contrast with the negative effects of FDI stock. While exposure to more FDI is significantly associated with lower risks to contract sanctity, exposure to more diverse FDI predicts higher risks to contract sanctity. Controls for political constraints and natural resources, on the other hand, do not have explanatory power.

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<sup>260</sup> Guriev et al 2009.

<sup>261</sup> See Appendix A2 for summary statistics and the list of countries used.

I use two additional types of data to test the robustness of results in Models (5) to (7). First, in Models (8) and (9), the dependent variables come from data on the pricing of political risk insurance for foreign investments. Using country experts and a proprietary model, the Belgian Export Credit Agency (ONDD) calculates risk ratings to capture its expectations that government actions will lead to political risk insurance payouts.<sup>262</sup> These ratings' accuracy thus inform the ONDD's success, and Jensen documents that other risk-evaluation firms also use the ONDD data.<sup>263</sup> The tie between these ratings and pricing decisions makes them a credible measure of expectations about government breach of contract in a country as a whole. Due to limited within-country variation, Models (8) and (9) employ region and year fixed effects, with robust standard errors clustered by region. All independent variables are again lagged.

Model (8) uses data from 1992 to 2001, when the relevant ONDD rating combined the likelihood that war, political violence, and/or expropriation would devalue foreign holdings. While governments may have less direct control over damages resulting from war and violence than over expropriation decisions, their inclusion in the measure nevertheless speaks to the link between government-tied actions and foreign firm property rights. The results in Model (8) are consistent with the previous findings. A one standard deviation increase in *FDI nationality mix* corresponds to approximately a two-point increase in risk on a five-point scale. This is a substantial change, roughly corresponding to the risk increase between Zimbabwe in 1992 and Zimbabwe in 2001, after the Mugabe government had begun large-scale nationalizations of foreign-owned farms. Since 2002, the ONDD has estimated expropriation risks independently, using a seven-point scale. Using

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<sup>262</sup> The Belgian Credit Agency (ONDD) uniquely makes this data publicly available.

<sup>263</sup> Jensen 2008.

this risk rating as the dependent variable in Model (9), the a one standard deviation increase in *FDI nationality mix* increases expropriation risks by two points. This is equivalent to the risk differential between Venezuela in 2005 and 2007, after the Chavez government nationalized the oil industry and began nationalizations in other sectors.

Thus, the positive and significant effect of *FDI nationality mix* on breach is robust to a variety of measures of expected and actual breach. This evidence strongly supports the hypothesis that a higher FDI nationality mix increases the likelihood of breach of contract in a country as a whole. In the next sections, I provide tests of the underlying causal mechanisms that lead to this result: investors are likely to respond in ways costly to the host government following breach with co-national investors, but not following breach with other investors.

Second, I use a measure of the actual incidence of breach, as captured by public IIAs that investors have filed against emerging economy host governments used in the dyadic analysis above. The filing of a public IIA marks an instance in which foreign investors' understanding of their contract sanctity is clearly in conflict with the host government's behavior. Granted, the data-generating process that leads to these international lawsuits is incredibly noisy. Nevertheless, as a robustness check, higher levels of the FDI nationality mix should be positively related to the incidence of public IIAs. Indeed, country-years with an FDI nationality mix above the mean are significantly more likely to have a public IIA filed.<sup>264</sup> In a regression framework, I use the annual count of public IIAs filed against a host country over the number of host country BITs, to account for the quantity of legalized

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<sup>264</sup>  $t = -14.870$ . While nationalizations (counted as one event per country-year) are rarer in the time period under consideration, country-years in which at least one firm is nationalized are close to significantly more likely to have above-average *FDI nationality mix* ( $t = -1.466$ ).



breach of contract claims relative to the legalization of foreign investors' rights. Because within-country variation is more limited when using this measure, identification is off of within-region change in legalized breach over time. In addition to region and year fixed effects, robust standard errors are clustered by region and all independent variables are lagged. Model (10) in Table 2A reports the results, which are consistent with Models (5) to (9). Here, a one standard deviation increase in *FDI nationality mix* corresponds to the increase in legalized breach in Moldova from 1999, when the ratio of IIA filings to BITs was one to twenty-seven, to Moldova in 2005, when the ratio increased to two to thirty-five.

The results thus far have established an effect of co-national breach on investment decisions at the firm level, and an effect of the FDI nationality mix on the likelihood of breach. One concern might be reverse causality: if the FDI nationality mix has a direct effect on investment decisions, this would mean that investors incorporate the FDI nationality mix into their decisions and then have a direct effect on breach. This concern is theoretically implausible: individual investors have little access to the information on the content and distribution of investment decisions necessary to make useful estimates of the future FDI nationality mix. Further, a causal story in which the FDI nationality mix influences investor decision-making would in fact have the opposite effect to that found here. Foreign investors would be more likely to pull out of locations with a high FDI nationality mix, thus lowering the mix (unless all national groups exit at an equal rate, in which case the mix would remain constant) in places with a high likelihood of government breach of contract.<sup>265</sup>

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<sup>265</sup> See chapter 3 for a fuller discussion.

As predicted by the theory, the results in Tables 2 and 2A show a positive and significant relationship between the likelihood of breach and the FDI nationality mix. Figure 3 uses data from the estimation in Model (5) to further alleviate concerns. This plot orders host countries along the Y-axis in increasing levels of mean expectations of contract sanctity (decreasing levels of expectations of *Contract risks*). If investor decision-making caused levels of contract sanctity, independent of the FDI nationality mix, we would expect to see a relationship between levels of FDI stock and contract sanctity. Instead, we see that mean FDI stock has no clear association with mean contract sanctity. The plot notes the cross-country mean of FDI stock in the estimation sample and levels one standard deviation higher and lower. Host countries that have both secure and insecure contracts lie in and out of this band. Thus, we see little either theoretical or empirical justification for concern about reverse causality. Moreover, while including the variable *FDI nationality mix* in the dyadic estimations above is theoretically implausible, it is insignificant and the results of interest on IIA filings are unchanged when in fact included.

## Conclusion

Foreign firms' responses to government breach of contract with foreign firms vary, even though conventional wisdom would have it otherwise. As shown in the dyadic analysis above, when foreign investors are of different nationalities, one firm's broken contract does not have a differential effect on the investment decisions of firms of other nationalities. When firms are of the same nationality, on the other hand, the incidence of a public IIA decreases bilateral FDI flows by millions, for several years into the future.

The monadic analysis above supports the prediction that governments gain space to break contracts when FDI nationalities are more diverse, thanks in part to the differential effects of breach on each nationality's FDI drawdown as evidenced by the analysis of dyadic FDI flows. Whether measured by investors' expectations about contract risks or broader definitions of political risks and government breach of contract, or measured by political risk insurance pricing or legalized instances of breach, the results of the analyses here show that a greater FDI nationality mix enables more host government breach of contract with foreign firms.

## Figures and Tables

**Table 1. Effects of co-national and other IIAs on directed dyad FDI flows in emerging economies<sup>^</sup> (1998-2008)**

	Model (1)	Model (2)	Model (3)	Model (4)
Co-national IIA (last year)		-0.00258** (0.00117)		
Other IIA (last year)		-2.75e-05 (0.000213)		
Co-national IIA (last 2 years)			-0.00263** (0.00111)	
Other IIA (last 2 years)			8.76e-05 (0.000267)	
Co-national IIA (last 5 years)				-0.00293** (0.00127)
Other IIA (last 5 years)				0.00145 (0.00100)
BITs, running total	8.67e-05 (5.80e-05)	8.67e-05 (5.80e-05)	9.86e-05 (6.44e-05)	0.000125* (6.99e-05)
Political constraints	0.000624 (0.000736)	0.000628 (0.000742)	0.000647 (0.000906)	0.00217 (0.00159)
Risks to property rights <sup>^^</sup>	-0.000922*** (0.000349)	-0.000902*** (0.000345)	-0.000994** (0.000399)	-0.000903* (0.000495)
Host country GDP per capita (logged)	0.00325* (0.00192)	0.00326* (0.00192)	0.00424* (0.00234)	0.00841** (0.00398)
Host country GDP growth	2.72e-05 (2.46e-05)	2.83e-05 (2.47e-05)	3.75e-05 (3.38e-05)	8.25e-07 (2.80e-05)
Host country population (logged)	-0.0249 (0.0229)	-0.0250 (0.0230)	-0.0266 (0.0255)	-0.0114 (0.0152)
Host capital account openness	-3.55e-05 (0.000332)	-4.90e-05 (0.000332)	-7.21e-05 (0.000383)	-1.63e-05 (0.000390)
Home country GDP per capita (logged)	-0.0101** (0.00442)	-0.0101** (0.00442)	-0.0107* (0.00566)	-0.00782 (0.00847)
Home country GDP growth	7.10e-05* (3.84e-05)	7.10e-05* (3.84e-05)	7.12e-05 (4.36e-05)	9.44e-05 (9.86e-05)
Dyadic trade (logged)	-0.000113 (0.000213)	-0.000108 (0.000213)	-3.85e-05 (0.000343)	0.000350 (0.000886)
World FDI flows (logged)	0.00308 (0.00294)	0.00314 (0.00295)	0.00300 (0.00333)	-5.04e-05 (0.00224)
Constant	4.857*** (0.376)	4.858*** (0.377)	4.886*** (0.425)	4.618*** (0.298)
Observations	12249	12249	10568	6010
Home-host dyads	2524	2524	2370	1447
R <sup>2</sup> (within)	0.01	0.01	0.02	0.02

Dyad and year fixed effects.

All independent variables (except World FDI flows) lagged one year.

<sup>^</sup> Dependent variable is the log of net FDI flows (US\$ billions) from OECD country *i* to emerging economy *j*. The underlying distribution is shifted so observations of negative net flows are retained (see text).

<sup>^^</sup> This is the dependent variable used in Model (5).

**Table 1A. Arellano-Bond estimation of the effects of co-national and other IIAs on directed dyad FDI flows in emerging economies<sup>^</sup> (1998-2008)**

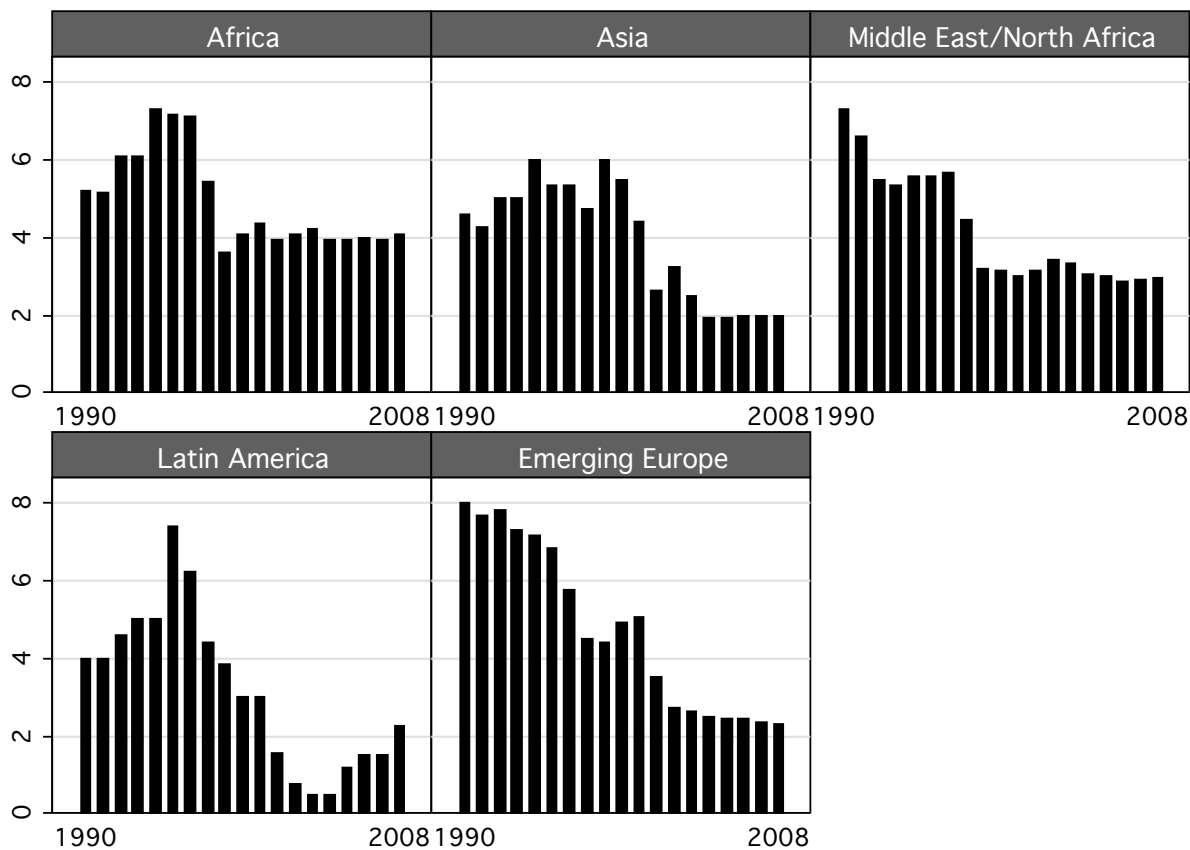
	(A)	(B)
Net FDI inflows (lagged DV)	0.0501 (0.0779)	0.0427 (0.0835)
Co-national IIA, last 2 years	-0.00366** (0.00145)	
Other IIA, last 2 years	-4.56e-05 (0.000296)	
Co-national IIA, last 5 years		-0.00609** (0.00255)
Other IIA, last 5 years		0.00282 (0.00225)
Distance between capital cities	0.000769*** (0.000125)	0.000896*** (0.000248)
Observations	7865	4434
Number of dyads	1925	1119

Year dummies not reported. 211 instruments.

*Controls* (all lagged): Host country: BITs, Political constraints, contract risks, GDP per capita, GDP growth, population, capital account openness. Home country: GDP per capita, GDP growth. Dyadic trade. World FDI flows. Robust standard errors, \*\*\* p<0.01, \*\* p<0.05.

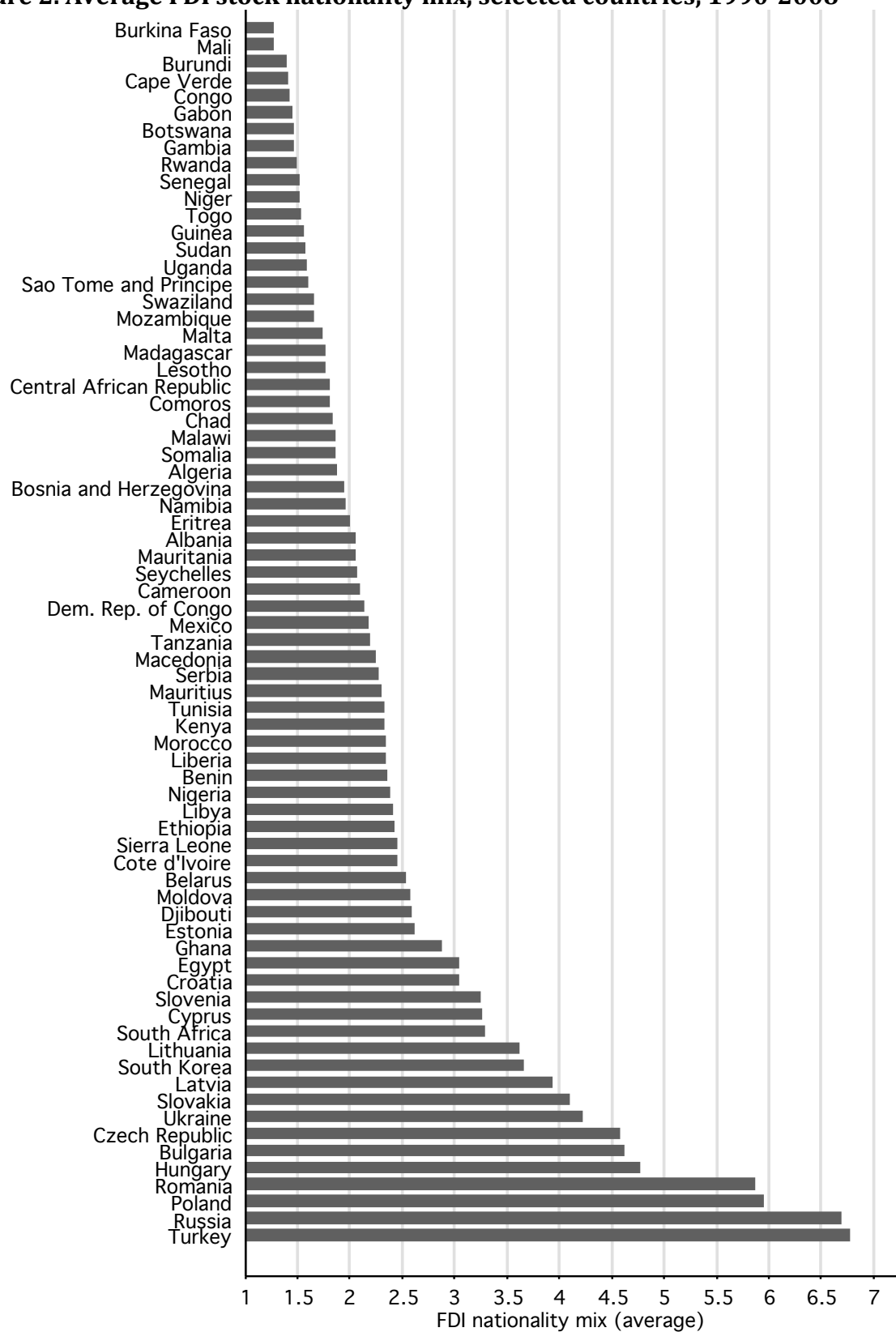
<sup>^</sup> See Table 1 for additional information on the data.

**Figure 1. Annual expectations of contract risks in emerging economies, summarized by world region, 1990-2008**



Source: International Country Risk Guide (ICRG) Risk Ratings, Political Risk Services.

**Figure 2. Average FDI stock nationality mix, selected countries, 1990-2008**



Source: Organization for Economic Cooperation and Development (OECD), FDI positions abroad.

**Table 2. Predicting investor expectations about government breach of contract (1990-2008)**

<i>Dependent variable</i>	<b>(Model 5)</b> Contract Risks <sup>^</sup> <i>[scale 0-12]</i>	<b>(Model 6)</b> (1) + FDI-related Corruption <sup>^^</sup> <i>[scale 0-18]</i>	<b>(Model 7)</b> (2) + Hold-ups + Law and Order <sup>^^^</sup> <i>[scale 0-24]</i>
FDI nationality mix	0.115** (0.0558)	0.204*** (0.0678)	0.276*** (0.0858)
FDI stock (logged)	-0.511*** (0.150)	-0.412** (0.159)	-0.338* (0.172)
BITs, running total	0.0133 (0.0119)	0.0152 (0.0116)	0.00143 (0.0128)
Natural resource exports	0.395 (0.940)	0.602 (0.607)	0.769 (0.715)
Political constraints	-0.00596 (0.737)	-0.442 (0.828)	-1.016 (1.077)
GDP per capita (logged)	-3.097*** (0.982)	-2.602*** (0.911)	-4.094*** (1.220)
GDP growth	-0.0386* (0.0197)	-0.0357 (0.0216)	-0.0304 (0.0304)
Constant	-2.617** (1.165)	-6.419*** (1.230)	-11.69*** (1.418)
Observations	674	674	674
Number of countries	52	52	52
R <sup>2</sup> (within)	0.62	0.40	0.28

Country and year fixed effects.

All independent variables lagged one year.

Robust standard errors clustered by country, \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

<sup>^</sup> ICRG Investment Profile. Composed of risks to contract viability, to profits repatriation, and of payment delays. Higher values = more risks.

<sup>^^</sup> Sum of ICRG Investment Profile and Corruption. Higher values = more risks.

<sup>^^^</sup> Sum of ICRG Investment Profile, Corruption, Bureaucratic Quality, and Law and Order. Higher values = more risks.



**Table 2A. Alternate measures of breach and propensity to breach (various years)**

<i>Dependent variables<sup>^</sup></i>	<b>(Model 8)</b> War and Expropriation Insurance price level <i>(1=low, 5=high)</i>	<b>(Model 9)</b> Expropriation Insurance price level <i>(1=low, 7=high)</i>	<b>(Model 10)</b> Legalized breach <i>No. of IIA filings / No. of BITs</i>
FDI nationality mix	0.0679*** (0.0183)	0.0485*** (0.0137)	0.00654*** (0.00145)
FDI stock (logged)	-0.0115 (0.0585)	-0.259* (0.152)	0.00264 (0.00301)
BITs, running total	0.0150*** (0.00578)	-0.00297 (0.00348)	
Natural resource exports	1.176*** (0.386)	1.169* (0.607)	-0.0316 (0.0265)
Political constraints	0.382 (0.391)	-0.546* (0.305)	-0.0129 (0.0182)
GDP per capita (logged)	-0.541*** (0.0671)	-0.699*** (0.0434)	0.00454* (0.00244)
GDP growth	0.0119** (0.00470)	-0.0127*** (0.00314)	-0.000137 (0.000319)
Region = Africa <sup>^^</sup>	-0.0141 (0.120)	-1.204 (0.966)	-0.115*** (0.0218)
Region = Asia	-0.565** (0.222)	-0.318* (0.188)	-0.156*** (0.00575)
Region = Emerging Europe	-0.682*** (0.221)	-0.584 (0.539)	-0.118*** (0.0138)
Region = Mid East/N Africa	-0.660*** (0.158)	-0.416 (0.752)	-0.126*** (0.0161)
Constant	2.689*** (0.382)	6.299*** (1.903)	0.109*** (0.0297)
Observations	328	382	775
Number of countries	54	59	65
R <sup>2</sup> (within)	0.23	0.28	0.02
Years covered	1992 - 2001	2002 - 2008	1990 - 2008

Year fixed effects.

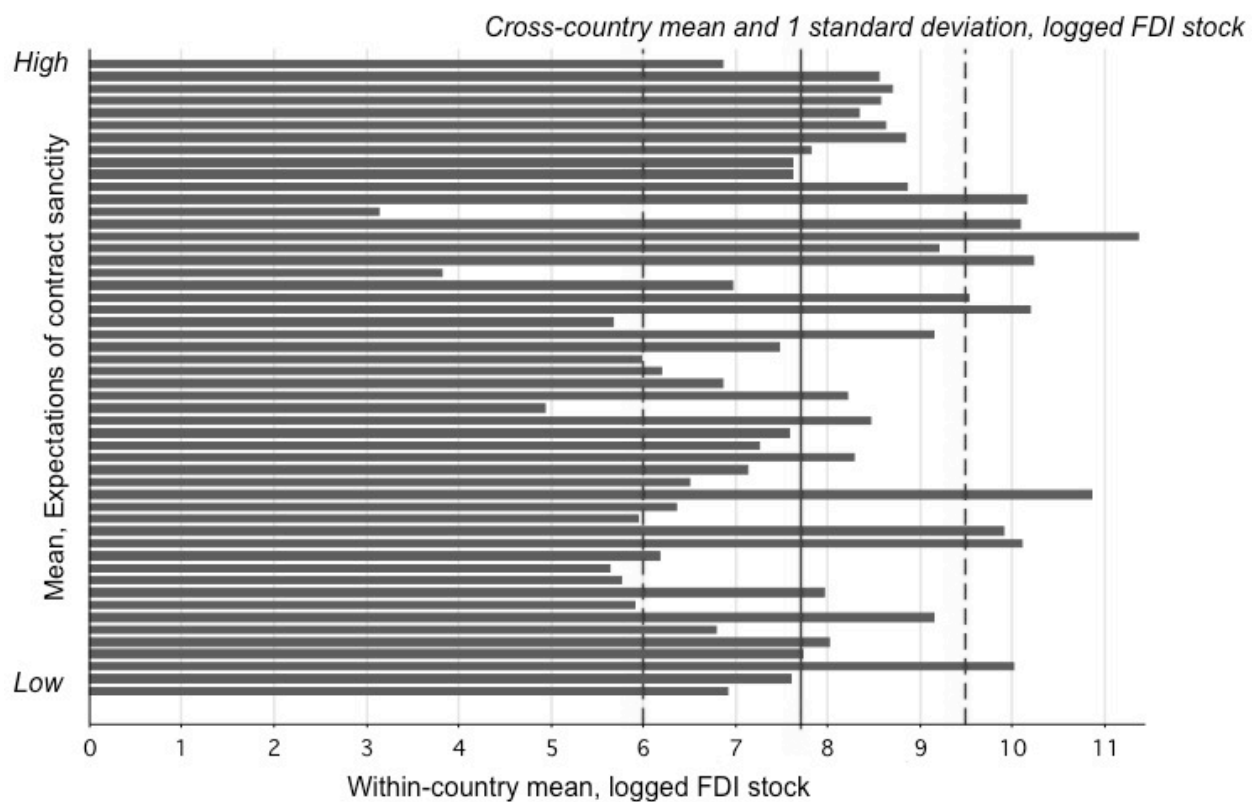
All independent variables lagged one year.

Robust standard errors clustered by region, \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

<sup>^</sup> Sources: UNCTAD; ONDD Belgian Export Credit Agency

<sup>^^</sup> Excluded region = Latin America

**Figure 3. Evidence against a casual effect of FDI stock on contract sanctity expectations, using estimation sample from Table 2, Model (5)**



## Appendices

Variable	Obs	Mean	Std. Dev.	Min	Max	Source
Net dyad FDI flow (log US\$ bln)	12249	4.420	0.011	3.545	4.619	OECD
Co-national IIA (last year)	12249	0.008	0.091	0	1	UNCTAD; author
Other IIA (last year)	12249	0.178	0.382	0	1	UNCTAD; author
Co-national IIA (last two years)	12249	0.015	0.121	0	1	UNCTAD; author
Other IIA (last two years)	12249	0.278	0.448	0	1	UNCTAD; author
Co-national IIA (last five years)	7366	0.037	0.190	0	1	UNCTAD; author
Other IIA (last five years)	7372	0.439	0.496	0	1	UNCTAD; author
BITs, running total	12249	30.735	23.426	0	119	UNCTAD
Political constraints	10924	0.306	0.207	0	0.73	Polconiii, Henisz (2010 [2002])
Risks to property rights	12249	-16.159	3.813	-26.5	-3	ICRG
Host GDP per capita (logged)	12239	7.582	1.312	4.415	10.484	World Bank WDI
Host GDP growth	12239	5.377	4.683	-41.3	46.5	World Bank WDI
Host capital account openness	12232	0.355	1.526	-1.844	2.478	Chinn and Ito 2006
Home GDP per capita (logged)	12249	9.788	0.683	8.267	10.940	World Bank WDI
Home GDP growth	12249	3.161	2.627	-6.854	10.579	World Bank WDI
Dyadic trade (logged)	11491	4.773	2.713	0	12.881	Correlates of War Trade; IMF
World FDI flows (US\$ bln)	12249	1248961	541186.5	565739	2099973	UNCTAD

### A1.A Summary statistics for Dyadic Tests

#### A1.B Host countries used in Table 1, Dyadic Tests

Angola	Congo	Ghana	Libya	Namibia	Slovak Republic
Albania	Croatia	Guinea	Lithuania	Niger	Slovenia
Algeria	Cyprus	Guinea-Bissau	Malawi	Nigeria	South Africa
Angola	Czech Republic	Hungary	Madagascar	Poland	Tanzania
Belarus	Egypt	Ivory Coast	Malawi	Congo	Togo
Botswana	Estonia	Kenya	Mali	Romania	Tunisia
Bulgaria	Ethiopia	Korea	Mexico	Russia	Turkey
Burkina Faso	Gambia	Libya	Moldova	Sudan	Uganda
Cyprus	Gabon	Latvia	Morocco	Sierra Leone	Ukraine
Cameroon	Gambia	Liberia	Mozambique	Senegal	

#### A1.C Home countries used in Table 1, Dyadic Tests

Australia	Hungary	Norway
Austria	Ireland	Poland
Belgium	Israel	Portugal
Czech Republic	Italy	Slovak Republic
Denmark	Japan	Slovenia
Estonia	Korea	Spain
Finland	Luxembourg	Sweden
France	Mexico	Switzerland
Germany	Netherlands	Turkey
Greece	New Zealand	United Kingdom
		United States

### A2.A Summary statistics for Monadic Tests

Variable	Obs	Mean	Std. Dev.	Min	Max	Source
Contract Risks, Model (1)	674	-7.859	2.107	-12	-0.083	PRS ICRG
Dependent Variable, Model (2)	674	-10.440	2.335	-16	-1.083	PRS ICRG
Dependent Variable, Model (3)	674	-15.975	3.555	-25	-5.333	PRS ICRG
FDI nationality mix	670	2.873	1.907	1	10.632	OECD; author
FDI stock (logged constant US\$ mln)	672	8.083	1.965	2.833	13.105	World Bank WDI
BITs, running total	674	23.568	22.959	0	93	UNCTAD
Fuels/metals exports (% merch. export)	656	0.228	0.268	0	0.997	World Trade Organization
Political constraints	627	0.301	0.202	0	0.73	Polconiii, Henisz (2002 [2010])
GDP per capita (constant US\$ thou.)	673	0.212	1.326	-2.191	2.741	World Bank WDI
GDP growth	673	4.380	3.765	-12.674	16.729	World Bank WDI

### A2.B Countries used in Table 2, Monadic Tests

Albania	Cyprus	Kenya	Moldova	Serbia
Algeria	Egypt	Korea	Morocco	Sierra Leone
Belarus	Estonia	Latvia	Mozambique	Slovak Republic
Botswana	Ethiopia	Libya	Namibia	Slovenia
Bulgaria	Gabon	Lithuania	Niger	South Africa
Burkina Faso	Gambia	Madagascar	Nigeria	Sudan
Cameroon	Ghana	Malawi	Poland	Tanzania
Comoros	Guinea	Mali	Romania	Togo
Congo	Hungary	Malta	Russia	Tunisia
Croatia	Ivory Coast	Mexico	Senegal	Turkey
				Uganda
				Ukraine

### A2.C Summary statistics, dependent variables in Table 2A, Monadic Tests

Variable	Obs	Mean	Std. Dev.	Min	Max
No. of IIA filings / BITs	1015	0.012	0.094	0	2
War and Expropriation Insurance price level	328	2.634	1.189	1	5
Expropriation Insurance price level	382	3.243	1.504	1	6

## **Chapter 5: Foreign firms and their Diplomats in Ukraine**

In Ukraine, the government sometimes engages in public contract disputes with foreign firms, and it sometimes ultimately breaks those contracts. According to the conventional wisdom, this is unexpected. Endowment-based explanations for a government's propensity to break contracts would predict breach in resource-rich Venezuela or a country with a large market like China. Ukraine shares neither of these traits. Rather, Ukraine competes for global capital against many possible destinations, making it the kind of country for which the need for contract sanctity has gone without question. Moreover, multilateral institutions scrutinize Ukraine and its market economy for progress in economic and political transition, making pressure to comply with property rights protections all the stronger. As a regular recipient of International Monetary Fund (IMF) loans, Ukraine has been able to maintain the sanctity of its sovereign bondholders' contracts. One might reasonably expect that a government under IMF and global market actors' scrutiny would want to uphold its commitments to other sources of capital, including commitments to foreign direct investors. Indeed, Ukraine has taken steps to establish credible commitments to foreign investors by, for example, entering 61 Bilateral Investment Treaties (BITs) as of 2011.

Nevertheless, the Ukrainian government has sometimes broken contracts, even under the pro-economic openness Orange Revolution government in 2005. In contrast, Ukraine increased its commitment to contract sanctity after the Orange government's collapse, though subsequent Ukrainian politics have been fractious and turbulent.

As Ukraine's fortunes have waxed and waned in its short history as an independent country, so too has Ukraine's FDI nationality mix varied as different nationalities of foreign firms entered and exited. Ukraine is therefore an important setting in which to trace the effects of investor nationality on the incidence of government breach of contract. Ukraine's FDI nationality mix breaks down into two periods: high and increasing in the late 1990s through the early 2000s, and lower after 2005. In this chapter, I connect the first period to multiple broken contracts with American investors. After 2005, the Ukrainian government repaired a long outstanding breach with an American investor, refrained from breach with a Norwegian investor, and canceled threatened breach with Russian investors. Finally, I examine the role foreign firms' national resources play in breach deterrence even when different nationalities face a common threat of breach or a firm has claims on more than one home country. Table 1 summarizes the contract disputes discussed in the text.

## **Ukraine's FDI nationality mix**

The nationality diversity of the foreign investor community in Ukraine was high and increasing from the 1990s through the early 2000s and lower from 2005 to 2008. In the first period, the unexpected break-up of the Soviet Union left governments scrambling to gain a foothold in newly sovereign countries. As one means to this end, governments promoted their nationals' investments in Ukraine as well as the broader region. For example, the US government supported American investment through programs at the Department of Defense, the Nuclear Regulatory Commission, the Department of Agriculture, the Ex-Im Bank, the US Agency for International Development, the Department of Commerce's Business Information Service for the Newly Independent States (BISNIS), and

more.<sup>266</sup> European investors also benefitted from a wide array of national programs and European Union-wide efforts. Additionally, a new class of Western entrepreneurs became “cowboys” running small- and medium-sized enterprises in what came to be called “the Wild East.” Foreign firms came to invest in Ukraine’s traditional strengths in agriculture and heavy industry as well as in manufacturing, finance, and retail.<sup>267</sup>

American firms accounted for the largest proportion of Ukraine’s FDI stock throughout the 1990s, but by 2003, a variety of Western and Eastern European investor nationalities had begun to catch up (see Figure 1). Ukraine benefitted from the economic success of transition countries in Central Europe, many of which were in final preparations to join the European Union on 1 January 2004. As the reform process had begun to raise costs in those countries, and accession to the European Union would make investments in those countries fully subject to EU standards, Western European investors began moving further eastward in search of low wages and low-cost inputs. Central European firms from Ukraine’s neighbor Poland as well as Slovakia, Latvia, and Hungary also joined the movement eastward. New investments flowed into industries like banking and light manufacturing, which made use of Ukraine as an export platform to the European Union.<sup>268</sup>

Russian investors quickly entered and grew their investments in Ukraine, a country with which Russia shares a long history and with a sizeable Russian minority.<sup>269</sup> In particular, Russians were ready participants in Ukraine’s privatization processes. Privatizations were integral to the process of breaking up one-time Soviet firms into

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<sup>266</sup> See for example the “Report on the implementation of the humanitarian and technical assistance program to the New Independent States of the former Soviet Union,” US Senate, 102<sup>nd</sup> Congress: 29 October 1992.

<sup>267</sup> Interviews, various, Ukraine. WIIW Database on Foreign Direct Investment in Central, East, and Southeast Europe (2009).

<sup>268</sup> Interviews (2), foreign firms in consumer goods and finance, Ukraine.

<sup>269</sup> In the 2001 Ukrainian census, Ukraine’s population was 17 percent Russian ethnicity and 77 percent Ukrainian ethnicity. Russian is widely spoken; several prominent politicians are poor Ukrainian speakers.

domestic firms in new countries, like the Russian Federation, that now acted as foreign investors in other new countries, like Ukraine. President Leonid Kuchma, in power in Ukraine from 1994 to 2005, presided over a government that brokered a number of notorious sales of state assets. Several of these involved Russian investors and went on to add fuel to the opposition in the Orange Revolution.<sup>270</sup> Russian investors' special access to these gray sales speaks to the role of nationality in differentiating risks to contract sanctity – especially when one nationality is more likely to be entering into government contracts with lower levels of legitimacy.

Cyprus also became a sizeable source of Ukraine's FDI stock. In large part this can be attributed to diaspora investors from Russia that use Cyprus as a home for their businesses, which accounts for Russia's otherwise small share of FDI in Ukraine in 2003 (see Figure 1). Russian individuals investing via Cypriot firms share historical and ethnic relationships with Ukraine unrelated to Cyprus. Nevertheless, Cyprus is a useful place for Russian investors to domicile their businesses because Cyprus is an EU member, because it provides tax benefits, and because of what Cypriot nationality means for their contract sanctity.<sup>271</sup> In particular, Cypriot investors share access to the Ukraine-Cyprus investment treaty from the Soviet era that is prominent enough for Ukraine's parliament to regularly debate withdrawing from it. The Ukraine-Cyprus Bilateral Investment Treaty (BIT) has been the basis for several public IIAs brought by Cypriot firms against Ukraine. The Ukrainian government understands that Cyprus is an attractive country from which to do business with Ukraine; in fact, some ethnic Ukrainians also use Cypriot firms to invest in

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<sup>270</sup> See section on *Nationality and a Common Threat*. Corruption has been a problem in privatization processes throughout the post-communist region. For an excellent treatment of the issue, see Schwartz 2006.

<sup>271</sup> Cypriot investors into Ukraine benefit from both a double taxation treaty as well.



Ukraine, whether as diaspora investors or as part of a phenomenon in which Ukrainian citizens “round-trip” investments.<sup>272</sup> Suffice it to say here that Russian, as well as Ukrainian, individuals who domicile firms in Cyprus share risks to contract sanctity as a result of this choice, and these firms take advantage of Cypriot legal resources to fight breach. Even if the extent of these shared risks and resources is not as great as if firms had invested out of the country of their CEO’s birth, for example, Cypriot investors share nationality-tied contractual arrangements and access to particular legal resources, making their presence add diversity to the FDI nationality mix just as a “traditional” nationality would. By 2003, Cypriot investors were the second largest group in Ukraine after American investors.

In short, a variety of OECD and regional investors were responsible for Ukraine’s increasing FDI nationality mix through the early 2000s. In an interview, one Ukrainian politician summarized the growing diversity of investor nationalities in this period by pointing to South Korean firms’ investment into auto parts manufacturing in the late 1990s. This event captured his feeling that Ukraine was truly integrating with the wider world economy, despite its status as a laggard in political and economic transition.<sup>273</sup>

Ukraine’s FDI nationalities became less diverse beginning with the biggest foreign investment in Ukraine as of 2012: the October 2005 sale of Ukraine’s major steel mill, Kryvorizhstal, to Mittal Steel for US\$4.8 billion.<sup>274</sup> This FDI infusion, which took place under the democratizing Orange Revolution government, sparked the interest of other major Western European multinationals. Together with Russian investors, multinationals

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<sup>272</sup> The implications of round-tripping for contract sanctity will be discussed in the section *Offshore Incorporation*.

<sup>273</sup> Interview, Ukrainian Member of Parliament, Ukraine.

<sup>274</sup> The section on *True Multinationals* discusses this sale as well as the role the complex national identity of Mittal Steel (soon ArcelorMittal) has played in its own contract disputes.

from a variety of Western European countries accounted for the subsequent FDI boom in consumer products, agriculture, and banking.<sup>275</sup> In contrast to 2003, Ukraine's top ten nationalities came to represent well over 75 percent of Ukraine's FDI stock by 2008 (compare Figures 1 and 2). This decreased the FDI nationality mix even as Ukraine's FDI stock grew rapidly. American-origin investment fell and now accounted for a relatively small proportion of Ukraine's FDI, thanks in part to a broken contract that is estimated to have cost Ukraine up to US\$1 billion in American investment from 1998 to 2008.<sup>276</sup>

Figure 3 plots two measures of Ukraine's FDI nationality mix. The first, based on FDI stock from OECD countries, is the quantitative variable used in the analysis in chapters 4 and 5, while the second incorporates data from twelve additional regional home countries such as Russia and Poland.<sup>277</sup> The change over time in the OECD-based measure is greater than that of the broader measure, which sets up a difficult test for the theory. Though OECD-origin firms are the ones most often thought of as stateless actors, the evidence presented here must demonstrate that even these firms' nationalities matter for their contract sanctity. Nonetheless, the two measures trace the same pattern of an increasing FDI nationality mix in the 1990s, with a peak around 2003-2004, and a less diverse environment after 2005. The diversity of investors present in Ukraine rose, peaked, and lowered. Foreign firms' abilities to deter contract breach moved in the opposite direction.

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<sup>275</sup> Interviews, various, Ukraine. WIIW Database on Foreign Direct Investment in Central, East, and Southeast Europe (2009).

<sup>276</sup> See the section on *American Failure, Failure, and Success*. Davis, Jim. "Ukraine's Outstanding OPIC Debt: A barrier to foreign investment," Business Ukraine Magazine (Kyiv, Ukraine): 11 February 2008. Reprinted by the US-Ukraine Business Council.

<sup>277</sup> Inverse  $HHI_{it} = 1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ . See chapter 3 for a deeper theoretical discussion of this measure. WIIW Database on Foreign Direct Investment in Central, East, and Southeast Europe (2009). The correlation between this and the OECD measure of Ukraine's FDI nationality mix is very high (0.75).

Indeed, reflecting on Ukraine's trajectory, the local head of a foreign private equity summed it up: "the biggest disputes in Ukraine happened before and through 2004."<sup>278</sup>

## **Foreign firm voice and diplomatic advocacy**

By using "voice" to articulate their concerns to both home and host governments, foreign firms can make the consequences of government breach of contract more visible and immediately threatening to the host government's interests in maintaining capital access.<sup>279</sup> Additionally, diplomatic advocacy by the home country can tie the incidence of a breach to other issues in the bilateral relationship, adding foreign policy costs to the costs of capital loss should the host government choose to breach. While some firms have privileged access to home country support by virtue of their size or political standing, coordinated efforts to press home governments for support keep a contract breach from being dismissed as the problem of only one.<sup>280</sup> Co-national firms' shared risks to contract sanctity and their ties through institutions in the home and host country make it easier for co-national firms to overcome collective action problems. For example, foreign firms of the same nationality can coordinate their appeals to their home government through nationality-tied investor associations. Such associations are often able to gain privileged access to host government decision-makers as well, as host governments benefit from having easy channels for communication with foreign firms. As a result, co-national firms

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<sup>278</sup> Interview, foreign firm in financial services, Ukraine.

<sup>279</sup> Hirschman 1970.

<sup>280</sup> In 2011, the British ambassador to Ukraine was well known among the foreign investor community for reaching out to British firms to encourage coordination. Interviews (5), American, British, German, Swedish, and French firms, Ukraine.

can use formal or informal associations as platforms to lobby the host government on behalf of their own contract sanctity.<sup>281</sup>

The likelihood that diplomatic pressure or collective lobbying among co-national firms will be successful in deterring breach depends in part on the broader set of foreign capital a host government might be able to substitute given deteriorating relations with any one national group. When a country is host to a greater diversity of national investor groups, co-national actors have less leverage over the host government's capital access. Given the lower likelihood of successful breach deterrence, diplomats and firms cut back their efforts. Scarce resources are better spent in protecting contract sanctity by other means. In contrast, each national group of investors has a larger role to play in the host country's current and future access to capital in times of a low FDI nationality mix, so host governments have stronger incentives to maintain contract sanctity. Accordingly, co-national actors are more committed to campaigns around contract disputes and more successful in deterring breach. These mechanisms of interest articulation and lobbying by and on behalf of co-national firms have played out in Ukraine repeatedly over the last decades. The following sections trace out contract disputes, investor and diplomatic voice, and ultimate breach or deterrence.

## **American failure, failure, and success**

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<sup>281</sup> In contrast, multinational investor associations bring together firms that are less likely to share contract risks. Advocacy around breach of contract is thus outside the scope of these associations' efforts, as it does not provide a common good to all members. Taking positions on government breach of contract would alienate members and undermine a multilateral associations' ability to undertake collective action on other issues. Interviews, various, Ukraine and Romania.

American collective action failed to halt the breach of twelve firms' contracts over the period from 1997 to 1999. The Ukrainian government's subsequent violation of its treaty commitment to the US Overseas Private Investment Corporation (OPIC) was not settled until 2009. OPIC is a US government agency that offers financing, investment funds, and political risk insurance for American investors in emerging markets, conditional on the host government's agreement to reimburse OPIC for political risk insurance claim payouts. The Ukrainian government failed for ten years to reimburse OPIC for a US\$17.7 million claim. As a result, Ukraine is estimated to have lost up to US\$1 billion in American investments that OPIC would have made or facilitated.<sup>282</sup> The twelve contract breaches in the late 1990s and the non-payment to OPIC stand in contrast to conventional expectations that an emerging economy government must uphold its contracts with foreign firms in an era of economic globalization. Why these breaches occurred and why it took so long to resolve OPIC's breach are puzzles, especially as OPIC was eager to reenter Ukraine.<sup>283</sup>

Unfortunately for American firms, an increasing FDI nationality mix from the late 1990s through the early 2000s enabled the Ukrainian government to breach contracts, because lost access to American capital became less consequential. Other national groups of investors were uninterested in supporting American efforts, and even American diplomatic pressure and co-national lobbying was ineffective. However, after failures to deter breach in 1997-1999 and again in 2004, American firms and diplomats successfully

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<sup>282</sup> Davis, Jim. "Ukraine's Outstanding OPIC Debt: A barrier to foreign investment," *Business Ukraine Magazine* (Kyiv, Ukraine): 11 February 2008. Reprinted by the US-Ukraine Business Council.

<sup>283</sup> The clearest hypothesis offered by those involved is that inter-agency bureaucratic confusion in the Ukrainian government led to consistent buck-passing (Interview, Washington, D.C., 2011). The explanation I offer here is that, while the Ukrainian government was reluctant to settle the breach for domestic reasons, successful foreign investor collective action was necessary to eventually carry the day. This is a more satisfactory explanation if only because Ukraine's Prime Ministers and Presidents were aware of the OPIC breach throughout the ten-year period and could have prompted quicker action had resolution been a priority.

came together on OPIC's behalf in the second half of the 2000s. Now with fewer other national groups of investors on which to rely for capital access, the Ukrainian government proved willing to follow through with restitution to OPIC after a ten-year delay.

### **American bluffs**

In 1997, the US government had major foreign policy interests in securing nuclear materials in Ukraine, establishing Ukraine's relationship to NATO, and gaining a foothold in Ukraine in part because of Ukraine's position vis-à-vis Russia. Despite these pressing "high politics" bilateral issues, the US Congress tied the distribution of foreign aid to Ukraine directly to the outcome of the government's contract disputes with twelve private, American investors – an action unprecedented in Ukraine or elsewhere in the post-communist region.<sup>284</sup> The US Congress threatened to withhold up to fifty percent of discretionary aid promised to Ukraine, amounting to about US\$80 million, if the Ukrainian government did not ensure that "United States investors who have been subjected to...inappropriate, corrupt activities carried out by officials or representatives of the Ukrainian government are provided with full restitution or compensation for their losses."<sup>285</sup> The legislation referred to the list of twelve firms assembled by the US Embassy in Ukraine, which including major American multinationals like Cargill as well as smaller investors. The US Secretary of State was to report to Congress on whether sufficient progress had been made to merit aid distribution, and the US Embassy in Ukraine was to

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<sup>284</sup> This threat harkened back to the long-dead "Hickenlooper Amendment" to the Foreign Assistance Act of 1962, which required the US government to suspend foreign aid to countries that expropriate American property without just compensation. Formal sanctions were applied only once, in Ceylon, before it was repealed in 1972.

<sup>285</sup> Congressional Record – House. June 11, 1997. Page H3698. Sec. 1717. Sense of Congress Concerning Assistance for Ukraine. Subsection (5). Amendment offered by Mr. Fox of Pennsylvania.

confirm restitution in a series of regular follow-up meetings with the Ukrainian government.<sup>286</sup>

Congress received the State Department's approval and distributed Ukraine's aid in full in 1998, despite the disapproval of American firms and investor associations in Ukraine. From the point of view of American investors, the Kuchma government had taken no action on these twelve firms' broken contracts and had not assuaged American concerns about their broader contract sanctity. Congress followed up with a similar threat to withhold aid from Ukraine in legislation in 1998: the US would not distribute the aid allocated to Ukraine in the 1999 budget if Ukraine did not make "continued progress on resolution of complaints by US investors."<sup>287</sup> The Kuchma government called the American bluff and again did nothing. This time, American investors in Ukraine accused the US Ambassador to Ukraine of "fudging the numbers" to overstate progress toward resolution, and Ukraine received its aid in full.<sup>288</sup> The mandated meetings between the US Embassy and the Ukrainian government to follow up on restitution never occurred.<sup>289</sup> Why did what appeared to be strong diplomatic support fail to push the Kuchma government to restore American firms' contracts?

The mix of foreign investor nationalities in Ukraine had increased in the years leading up to 1997, and 1997 to 1999 brought significant new entry of OECD-origin investors into the country (see Figure 3). Ukraine, which has been a transition laggard compared to its western neighbors, was just becoming an attractive investment destination

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<sup>286</sup> Interviews (3), Washington D.C.

<sup>287</sup> Congressional Record-Senate. S9999. September 8, 1998. Assistance for the New Independent States of the Former Soviet Union (b).

<sup>288</sup> "Pifer fudges the numbers," Kyiv Post: 25 February 1999.

<sup>289</sup> Interview, Washington, D.C.

with healthier macroeconomic fundamentals including economic growth and better control over inflation. American investors were early entrants into Ukraine, but large Western European countries now grew their investments and provided Ukraine with additional sources of FDI. Western European FDI gained a good reputation in Ukraine for promoting local development and economic growth. Economic integration with Western Europe also supported Ukraine's hopes to "return to Europe" now that its Soviet identity was gone.<sup>290</sup> Against this backdrop, the potential loss of US\$80 million in American aid and the further exit and deterrence of American-origin FDI posed less of a threat to Ukraine's capital access and international standing than it might have otherwise.

European-origin investors and their home governments had strong incentives to stay removed from American disputes. Far from facing risks to contract sanctity in Ukraine, Western European firms received privileges. In its efforts to turn westward to "become European" and eventually acquire entry to the European Union, Ukraine was particularly keen to build strong relationships with European home countries. American investors were frustrated about what they saw as discrimination. In testimony before Congress in 2000, the head of an American investor organization in Ukraine expressed his low expectations for collaboration between European and American investors.

It is common practice for these [post-communist] governments to be told by the Europeans, in some cases rather bluntly and in others rather delicately, that you had better remember which side your bread is buttered on when it comes to letting these contracts. Certainly I have run into this in the Ukraine, where Ukraine, which aspires to be an EU member, has been told in various ways in various cases that...contracts better go to German or French companies, not American companies.<sup>291</sup>

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<sup>290</sup> See again Figure 1. Interviews, various, Ukraine, Moldova, and Romania. Wilson 2005.

<sup>291</sup> "Treatment of US Business in Eastern and Central Europe." Hearing before the Subcommittee on European Affairs of the Committee on Foreign Relations, United States Senate (106<sup>th</sup> Congress, Second session): 28 June 2000.



This well-placed American executive saw that, far from worrying that the political problems of American firms were harbingers of their own future, European-origin firms benefitted from their own convivial government relations. European firms had little incentive to risk their privileges by getting involved in American firms' disputes.

Investors from transition countries were also indifferent to Americans' contract sanctity, as American disputes were not relevant enough to their own contracts or political risks to merit coordination with American efforts.<sup>292</sup> The context in which transition country investors' contracts were formed generated sharply different contract sanctity risks than those faced by American firms. The Soviet economy was characterized by soft budget constraints, meaning that bureaucrats' commitments to cut off funding to loss-making enterprises were not credible.<sup>293</sup> With the fall of the Soviet Union, some of the debts incurred thanks to soft budget constraints were now spread between different countries' state-owned enterprises. As privatization proceeded, both private and state actors became involved in negotiating inter-enterprise foreign debt settlements. In Ukraine, this meant that newly minted foreign investors from Russia and other countries in the region had to work out legacy debts together with their newly minted home governments and the newly sovereign Ukraine. Regional firms and governments were willing to write off the Ukrainian government's non-payment of an outstanding debt for a write off of their firms' legacy debts. For them, this was a mutually intelligible and legitimate transaction.<sup>294</sup> Regional firms making greenfield investments in Ukraine shared a common Soviet legacy that allowed contracts to be tacit and flexible when compared with American investors'

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<sup>292</sup> Interviews (3), Russian firms, Ukraine.

<sup>293</sup> For an excellent treatment of this problem, see Kornai 1992.

<sup>294</sup> For helpful models of how transition countries resolved these problems, see Roland 2004.

more arms-length, formal agreements. Without the historical interdependencies or flexible contracting that shaped regional investors' relations with the Ukrainian government, government non-payment could only be a breach of contract for an American investor.

Moreover, investors from post-communist countries have been exposed to different political risks as each of their newly separate governments worked out bilateral relations with Ukraine. These bilateral political risks are mediated by shared and sometimes conflictual cultural histories. Ukraine's bilateral relations in the region have also been shaped by the geographical distribution of assets like oil and gas pipelines that, with the fall of the Soviet Union, became sources of bilateral conflicts with Russia, Belarus, and other previous Soviet trading partners now separated by rigid national borders. Firms or diplomats from regional countries did not support the American efforts nor, we will see, did the United States support regional firms facing broken contracts.

Diplomatic advocacy on behalf of American firms was tied up with bilateral politics to which firms of other nationalities were not party, which further reduced incentives for other countries to support American efforts. The United States had multifarious reasons for maintaining a strong presence in Ukraine, and it became clear that the US government's threat of withholding aid in 1997 was not credible. Local actors saw the repetition of the same ultimatum in 1998 as an empty threat.<sup>295</sup> The Congressional legislation itself compromised the credibility of American commitments to repair contract breaches, as the conditional US aid was clearly distinguished from unconditional aid to restructure Ukraine's nuclear security. Aid designated for democracy promotion and market

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<sup>295</sup> Interviews (4), American investor associations, Ukraine and Washington, D.C., 2011.

restructuring was also unconditional.<sup>296</sup> These funding allocation choices demonstrated the US government's interests in growing, not shrinking, its influence in Ukraine. In 1999, a Congressional staffer summed up why the State Department had twice confirmed sufficient progress had been made to merit the full distribution of aid: "it obviously had other priorities than just defending US investor interests."<sup>297</sup> Another official lamented the "international brouhaha."<sup>298</sup> Given American actors' own weak commitment to advocacy against contract breach and other home countries' incentives to establish footholds in Ukraine, efforts to restore American firms' contract sanctity died out after 1999.

American firms had long pressed the US Embassy for support. Two American investor associations, the American Chamber of Commerce (ACC) and the US-Ukraine Business Council (USUBC), had privileged access to US officials and lobbied them on behalf of their memberships. In 1997, a US Congressman said that he knew that "25 percent of all...the Embassy [in Ukraine] does is expedite US business problems."<sup>299</sup> These associations also voiced the concerns of the American business community directly to Ukrainian officials. But American firms in Ukraine came to understand their isolated position and the weakness of the US government's actions on their behalf. Both the ACC and the USUBC strongly objected to the full distribution of aid in 1997-1998, but the ACC withdrew its objection to aid distribution the second time around. The ACC's leadership had changed from 1998 to 1999, and its new Managing Director took the firm stance that, "in the long term, [the distribution of aid] will result in a more favorable investment

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<sup>296</sup> For the terms of the 1998 ultimatum, see Congressional Record-Senate. S9999. September 8, 1998. Assistance for the New Independent States of the Former Soviet Union (b).

<sup>297</sup> "Pifer Fudges the Numbers," *Kyiv Post*: 25 February 1999.

<sup>298</sup> "US Presses Investor Disputes," *Kyiv Post*: 11 February 1999.

<sup>299</sup> Congressional Record-House. H3674. June 11, 1997. Comment by Mr. Hastings of Florida. He went on to say, "We cannot have people, either in tourism or in business, all over the world and not have our facilities to help them."

environment.”<sup>300</sup> The ACC offered no more public statements on the twelve American firms’ contract disputes. Since 1999, in fact, the ACC has refused to get involved in contract disputes between particular firms and the Ukrainian government.<sup>301</sup>

In contrast to the future promise offered by new investments from other national groups, American firms’ protests over contract sanctity were backward looking. The contract violations with the twelve firms began as early as 1992, in the turmoil of early transition and political and macroeconomic circumstances considerably more unstable than they were in the late 1990s. In 1999, the Ukrainian Prime Minister publicly placed fault for the firms’ contract breaches on the side of naive Americans that had gotten involved with “God knows whom.”<sup>302</sup> In a strange twist, Ukraine’s gray economy became useful political cover for the government’s inaction in repairing broken contracts. This framing went unchallenged by Americans.

In the late 1990s, foreign firm nationalities were becoming more heterogeneous and enabling the Ukrainian government to strain its relations with any one national group of foreign firms without jeopardizing its access to other current and future FDI. In such an environment, the Ukrainian government was unlikely to step back from contract breach with American firms. The US government was unwilling to incur the costs of following through with aid withholding and reducing its influence in Ukraine. The twelve firms contracts remained broken. At least one of the twelve firms went on to sue Ukraine under the US-Ukrainian BIT; another is still pursuing its case in Ukrainian courts as of 2011; a

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<sup>300</sup> “Pifer Fudges the Numbers,” *Kyiv Post*: 25 February 1999.

<sup>301</sup> Interview, American Chamber of Commerce, Ukraine, 2009.

<sup>302</sup> “US Presses Investor Disputes.” *Kyiv Post*: 11 February 1999.

third has made repeated, unsuccessful attempts to regain the US State Department's interest; and a fourth became the ten-year breach of contract with OPIC.

### **OPIC's broken contract**

Alliant Kyiv, formed in 1992, was a joint venture to recycle 220,000 tons of government-owned ammunition. The Ukrainian government owned 41 percent of the firm; its main contribution was to deliver the ammunition and grant Alliant Kyiv the rights to sell recycled materials on world markets. The US multinational Alliant Techsystems owned a 39 percent stake and, by 1998, had invested US\$22 million and trained local personnel to use a safer recycling process than the Soviet standard.<sup>303</sup> Alliant Techsystems bought political and expropriation risk insurance from OPIC to protect its investment. The joint venture became quite successful, making millions selling recovered gunpowder, industrial explosives, and, most importantly, scrap brass.

In the first ten months of 1998, Alliant Kyiv's exported 1,640 tons of brass for US\$2.13 million.<sup>304</sup> This was less than two-thirds of the volume of brass the Ukrainian Defense Ministry was obligated to deliver to the joint venture. Local observers speculated that the unexpected profits to be made in recycled materials tempted the Defense Ministry to process the materials itself, using the dangerous but cheaper Soviet method. There were reports that the Kuchma administration opposed the Defense Ministry's decision to breach, but Kuchma, likely wary of internal divisions in advance of the 1999 presidential elections, did not publicly address the Defense Ministry's disobedience.<sup>305</sup> Alliant Techsystems, the

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<sup>303</sup> A British firm (Rapierbase) and a Ukrainian firm (EKOP) each owned ten percent; they acted as "liaisons" for either side. "Rift threatens to blow up ammunitions joint venture," *Kyiv Post*: 30 October 1998.

<sup>304</sup> Ibid.

<sup>305</sup> Ibid.

US Embassy, OPIC, the Defense Ministry, and the Kuchma administration negotiated, but to no avail. In 1999, Alliant Techsystems ended its investment in Ukraine and received US\$17.7 million in compensation from its political and expropriation risk insurer, OPIC.

Unlike private market insurance providers or financiers, OPIC's participation in an emerging economy is contingent on the host government's agreement to reimburse it for any political risk insurance claims it pays out. Those involved with Alliant Kyiv's case at OPIC thought the reimbursement would not be a problem: the US\$17.7 million was a relatively small sum, OPIC had already facilitated over US\$200 million in investments in Ukraine and stood ready to do more, and its threat of exit was credible.<sup>306</sup> OPIC was also willing to negotiate over the terms of repayment and the public reasons for which that payment was made, as OPIC did not require Ukraine to admit guilt in the matter.<sup>307</sup> But Ukraine did not pay, and OPIC exited in 1999. In 2000, American investors gave Congressional testimony on their treatment in Ukraine, but OPIC's broken contract was not mentioned.<sup>308</sup> After the previous failure of diplomatic advocacy, OPIC's broken contract received little attention from the US government or other American investors.

OPIC continued to negotiate with the Ukrainian government, reaching a provisional settlement in 2004. The settlement turned out to be cheap talk. The Kuchma government agreed that OPIC would provisionally reopen operations in March 2004, conditional on the government repaying its debt by January 2005. But the Kuchma regime would be replaced in January 2005, either by Kuchma's preferred successor, Viktor Yanukovych, or the Orange

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<sup>306</sup> Interview, OPIC, Cambridge, MA.

<sup>307</sup> From OPIC's point of view, claims and reimbursements are intended to be "no fault." The payment means only that the host government participated in such a way that made the business lose money. Interviews (2), Washington, D.C.

<sup>308</sup> "Treatment of US Business in Eastern and Central Europe." Hearing before the Subcommittee on European Affairs of the Committee on Foreign Relations, United States Senate (106<sup>th</sup> Congress, Second session): 28 June 2000.

presidential candidate, Viktor Yushchenko. The Orange Revolution, from November 2004 to January 2005, overthrew the Kuchma regime and replaced it with the pro-reform, pro-Western democracy of the Orange coalition. It was also a major moment of turmoil in Ukraine's domestic priorities, bureaucracy, legal institutions, and more. From this point of view, fulfilling a settlement with OPIC may have understandably fallen by the wayside; an OPIC official recognized that "reinstatement is not a priority during elections."<sup>309</sup> However, the Orange Revolution government never took action on the settlement, and OPIC again exited in late 2005.

The Orange government's rationale for not providing restitution to OPIC was analogous to that offered by the Kuchma government in a 1998 letter: "payment of compensation to OPIC on an expropriation lawsuit in Ukraine may negatively affect foreign firms' opinion about the investment climate in Ukraine."<sup>310</sup> From the government's point of view, the inaction over OPIC did not in itself threaten the contract sanctity of other, non-American investors, but fulfilling its obligations toward OPIC constituted an admission of expropriation that would hurt Ukraine's appeal for all foreign investors.<sup>311</sup> So long as expropriation was only OPIC's interpretation of events surrounding Alliant Kyiv, American-origin FDI might be deterred, but other foreign investors would not receive an equivalent signal.

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<sup>309</sup> Interview, OPIC, Cambridge, MA.

<sup>310</sup> "Rift threatens to blow up ammunitions joint venture," *Kyiv Post*: 30 October 1998.

<sup>311</sup> In a colorful retelling, one American advocate recalled the Deputy Minister of Defense saying, "OPIC shafted us once – they'll shaft us again." (Interview, Washington, D.C.) In one of the last steps before restitution, a Memorandum of Understanding between the US Ambassador and the Ukrainian government read that resolving the breach "should not be considered as constituting any admission on behalf of the Ukrainian Side of any commitment, debt, complaint, or other claim of any company, including...Alliant Techsystems." "Bogdan Danylyshyn and William Taylor sign Memorandum," Ukrainian Ministry of Economy, Minister's Press office: 11 November 2008.

## Collective action and restitution

In October 2005, Mittal Steel invested US\$4.8 billion in Ukraine.<sup>312</sup> This investment, combined with new Western European investments in a variety of industries, left FDI less equally distributed across national groups. This reduced the effective number of national groups on which the Ukrainian government could rely for current and future FDI (see Figure 2). OPIC's long absence meant that fewer small and medium-sized American enterprises had been investing in Ukraine; by 2008, American-origin FDI had fallen to seventh place among OECD countries. Although American investors held a smaller share of the government's access to FDI, they now operated in an environment in which breach with any one national group carried higher costs for the Ukrainian government's future access to diverse sources of capital. These circumstances enabled American investors to come together to lobby the US government to take up OPIC's cause and to put direct pressure on the Ukrainian government to provide restitution and facilitate OPIC's reentry.

The US-Ukraine Business Council (USUBC) became the vehicle through which American firms lobbied the US government for support for OPIC, and the USUBC lobbied the Ukrainian government for restitution. Founded in 1995, the USUBC was first intended to be a close-knit club of large American firms investing in Ukraine, though the original members were mostly clients of the president's public relations agency.<sup>313</sup> The USUBC flexed its lobbying muscles during the failed 1997 to 1999 efforts on behalf of the twelve American firms with broken contracts, but it was mainly a networking and social forum. After the lobbying failure in 1999, dues-paying membership in the USUBC fell from twenty-

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<sup>312</sup> See section on *True Multinationals* for a discussion of this sale and Mittal Steel's role in shaping Ukraine's FDI nationality mix.

<sup>313</sup> Based on Interview, USUBC, Ukraine.



two to eight. In 2007, Sigma Bleyzer, a large private equity investor in Ukraine and elsewhere in the region, started rebuilding the USUBC as an association capable of promoting American business interests in Ukraine. With Sigma Bleyzer's financial and organizational support, the USUBC grew to 150 members by 2011,<sup>314</sup> including small and large American multinationals from a wide variety of industries. The USUBC membership also grew to include American firms that were interested in but had not yet entered the Ukrainian market, giving the USUBC the unique ability to represent deterred American investors as it lobbied the Ukrainian government. New USUBC members understand that they join an American-centric association that takes positions on particular firms' conflicts with the government, and members sometimes contribute extra funds in support of particular campaigns.<sup>315</sup>

The USUBC was made more important because the other American investor association in Ukraine was no longer identifying itself with American investors by the early 2000s. The American Chamber of Commerce in Ukraine had rebranded itself as "the Chamber" (hereafter Chamber/ACC), becoming a broad-based group with members from a variety of national origins. The Chamber/ACC now focused its lobbying efforts on the Ukrainian government and did not actively seek US government support. It advocated on issues around which the foreign business community was in consensus, which excluded particular instances of government breach of contract. The Chamber/ACC leadership perceives that lobbying on behalf of particular firms of any nationality would threaten the

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<sup>314</sup> Microsoft was eager to join as the USUBC's 100<sup>th</sup> member. The Ukrainian President attended a gala event celebrating its membership. Interview, USUBC, Ukraine.

<sup>315</sup> As one example of its American focus, the USUBC conducts all of its business in English so as to avoid the complications translation can cause. The USUBC does not talk to the Ukrainian media for this reason. Its meetings are always off the record. Interviews, USUBC, Washington, D.C. and Ukraine.

credibility it has built with the Ukrainian government as “the voice of foreign business in Ukraine.”<sup>316</sup> With this change to the Chamber/ACC, the USUBC was left as the only investor association interested in and capable of aggregating American interests around contract breach.

The USUBC took up OPIC as a cause in 2005. Some USUBC members expected to benefit directly from renewed access to OPIC financing or subsidized insurance.<sup>317</sup> But many of the USUBC’s members had little to directly gain from OPIC’s reinstatement. The USUBC’s large multinational members, including firms like Procter and Gamble, IBM, KPMG, and Halliburton, have other, cheaper sources of internal or external financing for projects compared to what OPIC can provide. Large firms are also often priced out of political risk insurance markets, or they use mechanisms like diversification and currency hedging to take account of politically derived risks.<sup>318</sup> Instead, such firms participated in the USUBC efforts in hopes of renewing Ukrainian commitments to American investors.<sup>319</sup> That the USUBC includes large, American multinationals has improved its clout with both the American and Ukrainian governments.<sup>320</sup> The US Ambassador to Ukraine attributed his strong and vocal support for OPIC to USUBC efforts.<sup>321</sup> The Ukrainian Vice Prime Minister

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<sup>316</sup> Interview, American Chamber of Commerce, Ukraine.

<sup>317</sup> In his advocacy efforts, USUBC President Morgan Williams repeatedly cited OPIC’s estimation that they had US\$500 million of investment committed to enter Ukraine upon reopening. USUBC workshops on OPIC financing held in early 2010 attracted 260 representatives from American firms. As reported by the US-Ukraine Business Council.

<sup>318</sup> The Ukrainian country leader at a major oil firm, who requested a copy of the interview questions in advance, was puzzled by the mention of political risk insurance. Before the interview, he asked around the office and called headquarters to see if the firm used it; he reported that an export credit agency might have supported the firm’s investment in a several billion dollar pipeline in China. Interview, foreign firm in oil and gas, Ukraine. Supported by Interviews, other large American, Western European, and Russian multinationals, Ukraine.

<sup>319</sup> Interviews, American firms, Washington, D.C. and Ukraine.

<sup>320</sup> Interviews, USUBC, Washington D.C. and Ukraine.

<sup>321</sup> The Ambassador was disappointed that OPIC was not fully reinstated before his term ended in mid-2009. Interview, USUBC, Washington, D.C.

who ultimately shepherded OPIC reinstatement through the government threw his support behind OPIC after a USUBC meeting in which the US Ambassador as well as firms like Microsoft, Baker & McKenzie, Cargill, and DHL took part.<sup>322</sup> Unlike the 1997 to 1999 efforts that quickly fizzled, the USUBC brought US diplomats and key Ukrainian politicians on board for a long campaign. The USUBC's leadership and representatives of its member firms became regular interlocutors with the US Ambassador and the Ukrainian President and Council of Ministers, discussing OPIC with them in at least 40 meetings from 2005 to 2009.<sup>323</sup>

Working together, American actors made the issue of an old broken contract salient to a Ukrainian government that was not responsible for either the original 1998 breach nor the breach of the provisional settlement in 2005. American actors' main task was to assuage the Ukrainian government's concerns that OPIC restitution would have a negative effect on non-American foreign investment. The two governments signed a Memorandum of Understanding in 2008 addressing this point, resolving that the breach "should not be considered as constituting any admission on behalf of the Ukrainian side of any commitment, debt, complaint, or other claim of any company, including...Alliant Techsystems."<sup>324</sup> In 2009, US Vice President Biden lauded this progress during a visit to Ukraine, saying that bringing OPIC back would "make it easier for American companies to

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<sup>322</sup> "Hryhoriy Nemyrya met with American investors," Press office of Vice Prime Minister of Ukraine: 31 January 2008. Reprinted by US-Ukraine Business Council.

<sup>323</sup> In 2008, USUBC President Williams stated that the OPIC dispute was under discussion in every meeting he had attended, in Washington or Kyiv, in recent years. Morgan Williams. "OPIC programs closed for Ukraine," US-Ukrainian Business Council News Release: 13 February 2008. Compiled from USUBC records.

<sup>324</sup> "Bogdan Danylyshyn and William Taylor sign Memorandum," Ukrainian Ministry of Economy, Minister's Press office: 11 November 2008.

reinvest in Ukraine, and invest in the first place.”<sup>325</sup> Two days before the final Council of Minister’s meeting to approve the restitution settlement in 2009, OPIC’s champion in the Ukrainian government took the unprecedented step of inviting the USUBC president to help draft the final resolution in order to avoid more bureaucratic hold-ups. Once signed, OPIC immediately restored operations.<sup>326</sup>

OPIC’s reinstatement took place thanks to the growth of the USUBC and its sustained efforts to organize American lobbying and diplomatic efforts. Interestingly, OPIC itself played only a small role in the multi-year campaign for its own reinstatement.<sup>327</sup> It was the USUBC that pulled in the support of American diplomats and key Ukrainian officials, taking advantage of its memberships’ interest in what OPIC’s reentry meant for the treatment of American investors more broadly. In comparison to the weak or non-existent efforts in times of a high and increasing FDI nationality mix in 1997-1999, the late 2000s brought an environment in which fewer other national groups were available to substitute for foregone American FDI. Faced with strong diplomatic and investor pressure for restitution from American actors, the Ukrainian government restored contract sanctity.

### **Considering alternative explanations**

When pushed for an explanation, American actors attribute the decade-long OPIC breach to inter-agency confusion within the Ukrainian government and bureaucracy.<sup>328</sup>

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<sup>325</sup> Statement by Vice President Biden after meeting with President Viktor Yushchenko of Ukraine. The White House, Office of the Vice President: 21 July 2009.

<sup>326</sup> Consistent with OPIC’s position all along, the settlement did not require a direct payment of US\$17.7 million. The agreed on US\$5 million payment is off-budget, to be paid in two payments per year over ten years. The funds are to come from a commercial group recycling leftover ammunition from Alliant Kyiv. This settlement, which perhaps favors the Ukrainian government, further demonstrates OPIC’s willingness to compromise in order to re-enter Ukraine.

<sup>327</sup> Interviews, OPIC and USUBC.

<sup>328</sup> Interview, OPIC, Cambridge, MA.

When the Ukrainian government violates a contract with a foreign firm, that firm interacts with low-level bureaucrats in the customs, tax, or other relevant administration, perhaps writing letters to gain a meeting with higher-level Ministry officials. Disputes remain housed within particular administrations, as there is no state structure with the overall mandate to interact with foreign firms.<sup>329</sup> Lawsuits are handled within the Ministry of Justice; only if a legal dispute becomes an IIA does the Ministry of Justice call a meeting with the Cabinet of Ministers, Prime Minister, and President.<sup>330</sup> Foreign firms in Ukraine are conscious of these institutional disconnects between government lawyers, low-level bureaucrats, and politicians at the highest levels. This is one reason that the USUBC's ability to cultivate relationships with top Ukrainian's politicians was important to OPIC's resolution. By aggregating American firms' voices, the USUBC gained the clout to bypass the bureaucratic apparatus and access politicians who can be difficult for even the most prominent of foreign firms to reach.

Yet bureaucratic confusion is an implausible explanation for the progression of American efforts. If it was only red tape that kept the Ukrainian government from realizing its genuine interest in resolving American disputes, it is unlikely that American actors would have given up their advocacy so quickly in the late 1990s and for so many years. Ukraine's successive Presidents and Prime Ministers were in fact aware of the OPIC issue and gave lip service to its importance over the breach's ten-year duration. Rather than attributing inaction to the issue being lost in Ukraine's bureaucracy, the explanation

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<sup>329</sup> At least four official agencies tasked with interacting with foreign firms have existed in Ukraine. Individuals in the foreign investment community, as well as at multilateral organizations, view these agencies as irrelevant. Interviews, various, Ukraine. Supported by Interview, current Ukrainian agency tasked with foreign investor relations, Ukraine.

<sup>330</sup> Interviews, (foreign and domestic) law firms representing both the Ukrainian government and foreign firms in international litigation, Ukraine.

offered here takes seriously the Ukrainian government's worries that restitution would be consummate to signaling the state's willingness to expropriate to all foreign investors. It also takes seriously the variation in American diplomats' and firms' willingness to support the cause. While by 2009 no significant changes had occurred in Ukraine's bureaucratic institutions dealing with foreign investors, renewed American interest in the cause more plausibly contributed to Ukraine's actions.

Industry-based collective action played no role in bringing about OPIC's restitution. We might expect that the political risk insurance and project finance industry in Ukraine would be interested in fighting the OPIC breach, for fear of the precedent it would set for their own interactions with the government. In Ukraine, members of this industry include OPIC-like agencies from other home countries as well as the Multilateral Investment Guarantee Agency (MIGA), the International Finance Corporation (IFC), and the European Bank for Reconstruction and Development (EBRD), all of which are multilateral organizations. Even with these organizations' public standing, they are still OPIC's competitors for project financing and insurance provision. Rather than signaling shared risks, OPIC's contract breach opened up a new set of potential American clients seeking political risk insurance and financing that now did not have the option of using an American institution.<sup>331</sup> Respondents at various organizations acknowledged the competitive advantage they gained from OPIC's "mistake": "OPIC really shouldn't have financed a business on a military base."<sup>332</sup> Given that other players in the industry did not see themselves engaging in analogous contracts, and that they gained competitive

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<sup>331</sup> It is hard to draw conclusions about the effects OPIC's absence might have had on pricing in the industry, as the terms of deals tend to be entirely project-based. Interview, European Bank for Reconstruction and Development, Ukraine.

<sup>332</sup> Interview, international organization, Ukraine.

advantages as a result of OPIC's absence, industry-based support for OPIC did not substitute for nor complement American actors' efforts.

## **Norwegians and the courts**

From 2005 to 2009, the Norwegian telecommunications firm Telenor was embroiled in a commercial dispute that spilled over into its relations with the Ukrainian government. The government faced significant pressure to breach its commitments to Telenor, not only from domestic sources but also from Russian business and political actors aiming to gain by Telenor's downfall. But with fewer other national investor groups to draw on in this period, the Ukrainian government was sensitive to retaining Norwegian investment. In fact, preserving Norwegian investment in Ukraine was necessary to keep the mobile telecommunications industry from being wholly Russian-owned, an outcome opposed by nearly all political players in Ukraine. While the Ukrainian government at times wavered in its treatment of Telenor, it ultimately did not break its commitment to the firm's fundamental rights to operate and own property. The preservation of Telenor's contract in Ukraine stands in clear contrast to Telenor's opposite treatment in Russia, where the Russian government expropriated Telenor in the context of a higher FDI nationality mix.

Telenor was the majority owner of Kyivstar, Ukraine's leading mobile service provider, and it invested US\$1.3 billion in Ukraine from 1997 to 2010. Telenor's conflicts grew out of its contentious relationship with Alfa Group, a Russian, oligarch-owned conglomerate. By 2005, Telenor and Alfa Group's partnerships were complex: Telenor was the majority owner of Kyivstar (57 percent) and Alfa Group was the minority owner (44

percent); in Russia, their positions were switched as Alfa Group was the majority owner of VimpelCom (44 percent) and Telenor was the minority owner (30 percent).<sup>333</sup> The core of the commercial dispute between Telenor and Alfa Group was over the interpretation of the shareholders' agreements in each of these ventures. Among other provisions, the Kyivstar agreement prevented either party from taking more than a five percent stake in a competing mobile provider, and the VimpelCom agreement required the board to approve any acquisition. The crux of the matter was that Russia's Alfa Group, both directly and via VimpelCom, invested in two Kyivstar competitors without Telenor's approval.

### **The conflict in Russia**

The VimpelCom conflict was specific to Russia, where Alfa Group is a domestic firm and Telenor is the foreign firm. Figure 4 shows that Russia's FDI nationality mix in the late 2000s has been higher than Ukraine's. As a large economy with a significant endowment of natural resources, Russia possesses the structural features expected to give its government leverage over foreign firms at the time of investment and after contracts have been struck.<sup>334</sup> Investors seeking to enter the Russian market or seeking access to Russia's resources must weigh their investment against the increased likelihood of breach of contract that these factors suggest. Moreover, throughout the 2000s Russia's political actors proved very willing to engage in high-profile conflicts with foreign firms, with strong evidence that the legal system has been manipulated to the detriment of foreign firm property rights. For example, foreign firms in oil and gas, including BP and Shell, have faced

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<sup>333</sup> For the ease of the reader, I use the parent firm, Alfa Group, to stand in for the various wholly owned subsidiaries that were involved in transactions with and litigation against Telenor. These include Storm LLC, Altimo, Eco Telecom, Alfa Telecom, and Alpren.

<sup>334</sup> E.g., Vernon 1971.



contract breach that reached international prominence. The continued entry of investors from many national origins into Russia, which has kept the FDI nationality mix high in the late 2000s, provides the Russian government with alternative sources of capital that further facilitate its recourse to contract breach.

The Norwegian government, which is the majority shareholder of Telenor, had previously intervened in Russia on the firm's behalf in 2000 and 2004, first to deter the Russian Communications Ministry from taking back allocated frequencies, and second to lower Telenor's suddenly high tax burden.<sup>335</sup> In the second half of the 2000s, however, Telenor lost several legal cases that were brought by shadowy shareholders and heard in obscure Siberian towns in what were seen by international observers as politically shaped rulings. Once these decisions began coming down against Telenor, Norway's government stepped back. In 2006, the Norwegian Trade and Industry Minister said his government would not interfere and that "there should be no concern that the conflict between Telenor and Alfa would scare away Norwegian investment in Russia."<sup>336</sup> With this statement, the Norwegian government explicitly attempted to downplay the bilateral implications of Russian actions against Telenor. In 2010, Telenor's accrued fines totaled US\$1.7 billion and the Russian government froze Telenor's assets, effectively halting its ability to operate in Russia.

Corrupt legal procedures had resulted in broken contracts in Russia before, but foreign firms of other national origins with similar experiences did not come to Telenor's aid. The British oil and gas firm BP had faced questionable court decisions that resulted in

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<sup>335</sup> "Norwegian Telenor offered ultimatum to VimpelCom." *The Russian Business Monitor*. 1 April 2005. (Original source: *Vedomosti*. 30 March 2005.)

<sup>336</sup> "Norway, Russia don't plan to interfere in Telenor, Alfa Conflict." *Ukraine Business Daily*. 16 March 2006.

its effective expropriation in the joint venture TNK-BP, but they made no public comment on Telenor's situation. Neither did the Swedish-Finnish telecommunications firm TeliaSonera, which faced risks directly analogous to Telenor's.<sup>337</sup> In an environment in which entry and reinvestment by a variety of national groups was the norm, and in which the Telenor dispute gained no supporters even from other firms facing similar problems, the Norwegian government explicitly stepped back from using its nationals' FDI in Russia as leverage in the Telenor conflict. The Russian government had little incentive to change its stance toward Telenor's operations in Russia and followed through with expropriation.

### **“The war against Telenor in Ukraine”**

Telenor's and Alfa Group's conflict in Ukraine began in earnest in 2005. Against Telenor's wishes, their Russian joint venture purchased a direct competitor to their Ukrainian joint venture, Kyivstar.<sup>338</sup> Having benefitted from the Russian government's breach of contract with Telenor in Russia, Alfa Group continued “the war against Telenor in Ukraine,” in the words of a major Russian newspaper.<sup>339</sup> Alfa Group's first Ukrainian lawsuit challenged the legality of Kyivstar's shareholders' agreement, though the agreement had been negotiated just one year prior. A Ukrainian court found in favor of Telenor and upheld the shareholders' agreement; the Ukrainian government publicly

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<sup>337</sup> TeliaSonera had a 44 percent stake in a Russian mobile firm (Megafon) and had been involved in its own shareholder dispute with Alfa Group, owner of a 25 percent stake.

<sup>338</sup> VimpelCom's board of directors had three members that are independent, three appointed by Telenor, and three appointed by Alfa Group. According to the shareholders' agreement, purchasing shares in other companies required an eighty percent majority of shareholder votes. “Russia's VimpelCom signs option to buy Ukraine's WellCom,” Prime-Tass English language business newswire. 18 March 2005.

<sup>339</sup> “Alfa Group continues the war against Telenor in Ukraine,” Russian Business Monitor. 22 April 2005. (Original source: *Vedomosti*, 20 April 2005.)

supported the verdict.<sup>340</sup> In this case, the Ukrainian legal system and government maintained commitments to contract sanctity, especially important given the international norm of government non-interference in private, voluntary agreements and the Commercial Code of Ukraine's explicit prohibition of "unlawful intrusion by governmental authorities and their officers in economic relations."

However, Alfa Group shortly began winning court cases in Ukraine, restricting the authority of Kyivstar's board of directors (August 2005), banning a board of directors meeting (December 2005), and requiring that Telenor and Alfa Group should have equal representation on the board despite Telenor owning 13 percent more shares (January 2006). The Ukrainian Supreme Economic Court upheld this last ruling (February 2006).<sup>341</sup> In 2007, a court ruling forbid Ernst & Young from auditing Kyivstar without board approval, which was impossible to get as Alfa Group had been boycotting Kyivstar's board meetings for nearly two years. Not only the verdicts in these cases but also their existence were contrary to the shareholders' agreement, which stated that all conflicts would be resolved in international courts and would not be prosecuted under Ukrainian law. By hearing these cases, the judicial system was complicit in a violation of the shareholders' agreement. Ruling on a case brought by Telenor, an international judge called Alfa Group's lawsuits "collusive and vexatious litigation" and wrote that Ukrainian legal opinions "appear to be nothing more than a sham."<sup>342</sup> The Ukrainian courts did not respond immediately or in full to this or other international rulings requiring them to stop hearing cases brought by Alfa

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<sup>340</sup> Ukraine had only vague law on joint-stock companies at this time. The clearest law was that shareholders' meetings require the presence of owners of at least sixty percent of the firm's shares. Interview, academia, Washington, D.C.

<sup>341</sup> "Prosecutor General's Office opens criminal case." *Ukraine Business Weekly*. 10 October 2006.

<sup>342</sup> "US Federal Court grants Telenor motion, holds Altimo in contempt, imposes fines and orders Altimo to sell shares," Marketwire. 20 November 2008. Original distribution: Hugin.

Group. However, Ukrainian courts did begin to find in Telenor's favor and Alfa Group dropped a number of lawsuits in late 2007.<sup>343</sup>

To what extent did the Ukrainian government itself break its commitments to Telenor, beyond the actions of the judicial system? The government ultimately stayed shy of violating Telenor's rights to operate and own property in Ukraine, despite being pushed to breach by Russian interests. In Russian-speaking eastern Ukraine, Russian investors enjoy privileged access to political life and popular support thanks to ethnic ties and their enterprises' provision of local employment. The Russian government had also shown itself willing to intervene in Russian commercial operations abroad and in Ukraine in particular. These considerations likely motivated Members of Parliament from eastern jurisdictions to, in 2006, argue that three appeals court judges had "deliberately pass[ed] an illegal sentence or ruling" in favor of Telenor.<sup>344</sup> The Ukrainian government opened a prosecution not of Telenor but of these three judges, though the case was shortly abandoned. Importantly, this action reveals that even the Ukrainian government actors most biased against Telenor used domestic targets to score political points over the dispute, rather than pursuing state action against Telenor itself. After this lawsuit, in fact, the Ukrainian administration began taking a more vocal stand against judicial misconduct that favored Alfa Group. For example, the Vice Prime Minister referred to Telenor when he said, "the

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<sup>343</sup> While the international ruling likely influenced the Ukrainian government's behavior, it did not stop all judicial mistreatment of Telenor: one Ukrainian court ruled that the New York arbitration was unenforceable in Ukraine, despite Ukraine's membership in the international convention on the enforcement of foreign arbitral rulings (October 2007).

<sup>344</sup> Ibid.

situation in Ukraine has reached absurdity when any district court can determine the fate of a serious strategic enterprise.”<sup>345</sup>

The Ukrainian government occupied an awkward space between vocal opposition of the judiciary and an attempt to keep distance from the conflict in sensitivity to its relationship with Russia. It was saved from this balancing act when Telenor and Alfa Group came to an understanding in 2009 and merged their Russian and Ukrainian ventures.<sup>346</sup> Though judicial corruption had an effect on Telenor’s contract sanctity in Ukraine, actors in the Ukrainian executive and legislature refrained from taking actions tantamount to expropriating Telenor. For example, in contrast to the situation in Russia, the Ukrainian government never froze Telenor’s assets. In fact, despite its most intense years of conflict in 2006 and 2007, Telenor’s profits from Kyivstar in 2007 were US\$316 million, a year-on-year increase in profitability of 54 percent.<sup>347</sup>

Telenor’s conflicts occurred in a time of a relatively low FDI nationality mix. Like the American investors advocating on OPIC’s behalf at the same time, Norwegians were not the largest or most prominent national investor group in Ukraine. But with fewer alternate options for FDI, the Ukrainian government was interested in retaining Norwegian presence in Ukraine. In fact, the Ukrainian government explicitly sought to maintain what national diversity Ukraine had among its foreign investors in telecommunications. If Telenor had exited the Ukrainian market, powerful Russian firms would have controlled Ukraine’s telecommunications industry.<sup>348</sup> Russia’s prominence in Ukrainian politics can make some

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<sup>345</sup> “Telenor supports anti-raiding commission of Ukrainian government.” *The Ukrainian Times*. 14 March 2007.

<sup>346</sup> The Ukrainian Anti-Monopoly Commission reviewed and approved the merger after responding to an appeal from another mobile operator in Ukraine.

<sup>347</sup> “Ukraine: Telenor profit exceeds US\$316mn.” *Emersk Ukraine News* (via Sostav.ua): 25 July 2008.

<sup>348</sup> The number two mobile provider in Ukraine had been the Russian firm MTS.

politicians willing to privilege Russian firms, but even Russian-sympathetic politicians oppose deals that would cause Russian ownership of an entire Ukrainian industry. Thus, Telenor's exit would leave Ukraine without realistic alternate sources of telecommunications capital, decreasing its leverage over Russian investors not to mention its recourse to contract breach. A low FDI nationality mix, within the industry and the economy, thus played a role in the Ukrainian government's ultimate maintenance of Telenor's property rights. Norwegian actors were able to capitalize on this concern through diplomatic channels and by illuminating the effects Telenor's exit would have on other Norwegian investments.

### **Norwegian collective efforts**

In contrast to the situation in Russia, Norwegian efforts on Telenor's behalf in Ukraine were considerable. Norwegian actors had for many years been committed to making their presence known in Ukraine as a national group. In 2004, before Telenor's conflict with Alfa Group had gotten underway in Ukraine, but when spillover from the Russian conflict seemed likely, Telenor's top executives from Norway met with then President Kuchma, who "marked how important it is for Ukraine to optimize bilateral relations with Norway."<sup>349</sup> The Norwegian Ambassador and the Norwegian Minister of Trade and Industry met with Ukrainian officials to discuss, among other things, "prospects for Kyivstar's development."<sup>350</sup> A variety of Norwegian investors were present at these meetings, including a producer of farm equipment, a fish exporter, and a ship-building firm, all of which had made major investments in Ukraine but none of which were involved in

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<sup>349</sup> "Kuchma orders to open Ukrainian embassy in Norway in near future." *Ukraine Business Report*. 30 January 2004.

<sup>350</sup> Ibid.

Telenor or Kyivstar directly.<sup>351</sup> As in the case of American multinationals acting on behalf of OPIC, being Norwegian suggested enough similarities for these firms to offer a common front to the Ukrainian government. Kuchma subsequently opened a Ukrainian embassy in Norway. That these niceties occurred in 2004, at the peak of the FDI nationality mix in Ukraine, suggests that the Ukrainian government had a particularly positive view of Norwegian investors even when any one national group's presence in the economy carried less weight.

As the Telenor dispute progressed, the esteem Norwegian investors had in Ukraine deteriorated. In 2007, signs appeared on Kyiv streets and outside Telenor's offices that read "Norwegians! Respect Ukrainian Laws!!" and "Norwegians, go home!"<sup>352</sup> An Alfa Group document soon emerged, entitled "Logical Rationale for the Information Campaign under the Kyivstar Contract," that read in part: "in order to break the existing stereotype whereby Western business and, in particular, Norwegian business always plays fair, an information wave of negative publicity should be started."<sup>353</sup> An accompanying spreadsheet suggested that Alfa Group's Ukrainian subsidiary should spend US\$75,000 buying press coverage against Norwegians in just two months of 2007.<sup>354</sup> These attacks were not framed against Telenor in particular, but against Norwegians as a national group. Even if Norwegians had not thought of themselves as a cohesive group, their detractors were willing to spend money characterizing them in such a way. In other words, foreign firms commonly held the idea that nationality mattered to public and, in turn, political perceptions of FDI. Alfa

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<sup>351</sup> "Norway to boost investments in Ukraine." *Ukraine Business Weekly*. 29 March 2004.

<sup>352</sup> "How the Kremlin thawed a telecoms freeze in Siberia." *The Evening Standard (London)*: 17 November 2008, p. 29.

<sup>353</sup> Kramer, Andrew. "Russian Company accused of buying press coverage." *The New York Times*. 14 March 2007. In fact, firms buying press coverage has not been uncommon in countries of the former Soviet Union.

<sup>354</sup> *Ibid.*

Group's efforts aimed at isolating Norwegians from other nationalities so as to differentiate the legitimacy and importance of their contracts from those of others. While interview respondents at firms from other home countries were personally outraged by this anti-Norwegian sentiment, they nevertheless saw no incentives to publicly coalesce with Telenor or Norwegians, as predicted by the theory outlined here.<sup>355</sup>

Once Alfa Group's negative campaign made Norwegians' implicitly shared risks explicit, Norwegian firms and diplomats redoubled their efforts on Telenor's behalf. Building on their strong bilateral relations from before Telenor's conflict began, Norwegian actors used both sticks and carrots with the Ukrainian government. With the Norwegian government as a co-author, Telenor publicly petitioned the Ukrainian government to investigate the "objectivity, impartiality, and independence of judges" regarding their "interference with good corporate governance and business morals."<sup>356</sup> At the same time, Norwegian interests formed the Norwegian Chamber of Commerce, which highlighted in its public statements that Ukraine's market "could be very promising not only in the area of communications."<sup>357</sup> These visible examples of co-national lobbying and diplomacy are the tip of the iceberg of efforts that occurred regularly behind closed doors from 2005 to 2009.<sup>358</sup> The Ukrainian government had incentives to maintain a higher FDI nationality mix – particularly in telecommunications – by keeping Telenor invested in the country, and Norwegian actors made it clear that Norwegian investment more broadly and Norway's good relations with Ukraine were at stake if the Ukrainian government took adverse action

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<sup>355</sup> Interviews, American, French, British, and Swedish firms, Ukraine.

<sup>356</sup> By September 2006, Alfa Group had initiated nine cases in Ukrainian courts demanding changes in Kyivstar's charter and shareholders' agreement. "Telenor asks authorities to investigate outcome of 11 rulings of Ukrainian courts." *The Ukrainian Times*. 14 February 2007.

<sup>357</sup> "Norwegian-Ukrainian Chamber of Commerce established." *Comtex News Network, Hugin AS*: 21 November 2008.

<sup>358</sup> Interviews, Ukraine.



against Telenor. With these pressures counteracting Alfa Group's influence, the Ukrainian government refrained from contract breach.

### **Considering alternative explanations**

As an investor from Europe, albeit not from the European Union, one alternative explanation for Telenor's ultimately intact contract is that it received support from other European countries' diplomats or firms. Over the 2000s, a European Business Association (EBA) had grown to represent the interests of investors into Ukraine that originated from across Europe. Telenor is a member of the EBA and its top executives in Ukraine have served on its board. In interviews, executives at two prominent European firms said that the EBA is willing to advocate on behalf of individual firms, mentioning Telenor as one example. Were this true, it would tend to undercut the argument that co-national collective action and not multinational collective action was an important determinant of the outcome of Telenor's contract dispute.

In fact, top administrators at the EBA were adamant in interviews that the EBA does not advocate on behalf of particular firms, nor did it advocate on Telenor's behalf.<sup>359</sup> These administrators carry out the work of the EBA, by writing letters to officials, maintaining government contacts, facilitating meetings, and providing the EBA's public face in Ukrainian and expatriate media. That EBA staff do not see the EBA as a forum for particular firms to resolve their grievances with the government reveals a disconnect between certain investors' beliefs about the EBA's activities and what the it actually does. It is possible that individual executives advocated on Telenor's behalf thanks to government connections

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<sup>359</sup> Interviews (3), EBA, Ukraine.

facilitated by the EBA, but this advocacy would have been isolated and undercut by the EBA's deliberate inaction on behalf of Telenor.

For example, the EBA set up in 2008 a number of working groups on corporate raidership, the crux of the problem facing Telenor.<sup>360</sup> Telenor approved of this as well as the concurrent establishment of a government commission on corporate raidership. The EBA president, however, specifically pointed out to the Norwegian press that EBA efforts against raidership were not on Telenor's behalf.<sup>361</sup> The equally multinational Chamber/ACC worked together with the EBA to lobby the Ukrainian Parliament for legislation codifying shareholder rights and closing loopholes that had facilitated raidership. Both organizations consider the legislation's adoption a great success story.<sup>362</sup> Nevertheless, the head of Telenor's operations in Ukraine stated plainly that this legislation "does not directly influence the [Telenor-Alfa Group-government] conflict."<sup>363</sup> Telenor's experiences provide a good illustration of the comparative advantages of multinational investor associations versus nationality-based associations. Investors from a variety of home countries share interests in certain kinds of business-friendly policy and can come together to lobby around issues like broad-based legislation. But multinational investor associations shy away from individual firm's conflicts with the government. Because member firms of different nationalities do not share the same determinants of contract sanctity, they do not share a general interest in expending resources on individual investors' contract disputes. For example, in an interview at a firm from a small, Western

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<sup>360</sup> From many analysts' point of view, Alfa Group's actions toward Telenor amounted to raidership: Alfa Group sought to change the balance of power in its partnerships with Telenor, with the ultimate intention of pushing Telenor to sell out so that Alfa Group could merge the Russian and Ukrainian operations.

<sup>361</sup> "Ukraine: Telenor accuses Altimo of raid attempt." *Esmerk Norway News*. 10 April 2008.

<sup>362</sup> Interviews (4), American Chamber of Commerce and EBA, Ukraine.

<sup>363</sup> "New law on joint-stock companies not to settle conflict around..." *Ukraine Business Weekly*: 13 October 2008.

European country, the local CEO lamented that there was no European Union-tied lobbying group, let alone an EU “embassy,” that would represent firms from small sending countries in their contract disputes.<sup>364</sup>

One interpretation of the outcome of Telenor’s conflict could be that the Ukrainian government did breach a foreign firm’s contract: that of Russia’s Alfa Group. From the point of view of Alfa Group, and other Russian actors that likely advocated on its behalf behind closed doors, the Ukrainian government’s refusal to support its claims outright could be a violation of at least informal government commitments to the firm. The wholly different perspectives of Norwegian and Russian firms in this case goes to support the argument that all foreign firms cannot be considered as a single entity: interpretations of government actions can vary by investor national origins, just as expectations of contract risk vary by national origin. Because international courts validated Telenor’s claims in this case, relating the case from Telenor’s point of view aligns with the most objective understanding of the Ukrainian government’s actions. That the Ukrainian government showed restraint toward Telenor’s contract goes to show that a firm from a major investor home country like Russia did not have sufficient leverage to negate a small national investor group’s contract sanctity.

## **Nationality and a common threat**

National origin is a key source of shared risks to contract sanctity, albeit not the only one. Yet national origin is a consistently important source of diplomatic and inter-firm resources to fight breach of contract. Put another way, in a situation where threats to contract sanctity extend across national groups, co-nationality should still provide avenues

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<sup>364</sup> Interview, Ukraine.

for foreign firms and their advocates to lobby against breach. Such a situation presented itself in Ukraine in 2005, when the Orange Revolution government threatened to nationalize and reprivatize assets across the economy. Foreign firms of all national origins interpreted these threats as pertinent to their contract sanctity. Despite this common threat of breach, it was nationality-tied resources that provided a ready source of powerful home country support and inter-firm lobbying efforts for foreign firms to successfully deter breach in Ukraine.

In January 2005, the Orange Revolution produced a coalition government with Viktor Yushchenko as President and Julia Tymoshenko as Prime Minister. In February, Tymoshenko created headlines when she announced that the government had a list of “3,000 cases of illegal privatizations” that it would nationalize and reprivatize; Tymoshenko proclaimed, “we will return to the state that which was illegally taken from it.”<sup>365</sup> The Finance Minister tried to clarify this statement, saying that the list of 3,000 privatizations “may increase, but this does not mean a declaration of war against all private owners.”<sup>366</sup> A week later, Members of Parliament proposed legislation to legalize nationalization that meets “the social needs of the state and municipalities,” omitting consideration of Ukraine’s international legal obligations to foreign investors such as those incurred through Ukraine’s BITs.<sup>367</sup>

A local political analyst’s summary of the reprivatization threat was apt: “Tymoshenko is still behaving like a revolutionary and is playing the populist card.”<sup>368</sup>

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<sup>365</sup> “Daily Alert – PM sparks unease over sell-off review,” *Emerging Markets Daily News*: 17 February 2005.

<sup>366</sup> “Ukrainian finance minister plays down mass reprivatization fears,” *BBC Monitoring Ukraine and Baltics*: 18 February 2005. Taken from a televised interview on Ukrainian ICTV television. Reported by *Interfax-Ukraine*.

<sup>367</sup> “Nationalization legislation proposed,” *Interfax-Ukraine News Service*: 25 February 2005.

<sup>368</sup> “Ukraine’s Yushchenko slaps down PM on privatization threat,” *Agence France Presse*: 18 February 2005.

Reprivatization was popular indeed. A 2005 poll found that 71 percent of Ukrainians supported Tymoshenko's plan to revise privatization results, with 81 percent in support in the populous and cosmopolitan Kyiv and Central Ukraine.<sup>369</sup> This sentiment was largely a reaction to the Kuchma government's notorious sales of state assets at fire sale prices to political insiders, leading a member of parliament to lament, "[sixty percent] of Ukrainian industry has been sold for 2 billion hrivnyas [US\$3.7 million]! What bureaucrats call privatization has in fact turned out to have been a brutal robbery of state property."<sup>370</sup> Indeed, backlash against legacies of corrupt, insider, and otherwise non-transparent privatizations are common across post-communist countries: in a 2005 regional survey, over 80 percent of 27,000 respondents wanted their governments to demand additional payments from private owners *ex post*, resell property for higher prices in new tenders, or return property to state ownership.<sup>371</sup> Unskilled workers and individuals in post-communist democracies have been more supportive of reprivatization, which played to the populist base Tymoshenko developed during the Orange Revolution.<sup>372</sup>

President Yushchenko protested that Tymoshenko's plan sounded like "a full revision of privatization processes in Ukraine," but reprivatization's popularity and Ukraine's need for cash to fund its budget kept him from wholly opposing it.<sup>373</sup> In the weeks that followed the original announcement, Yushchenko assured reporters that the "exhaustive list" of privatizations to be reviewed would be not zero but forty, then "several

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<sup>369</sup> Poll in Ukraine, by the Kyiv International Institute of Sociology. "Poll: 71.3% of Ukrainians back privatization." Interfax News Service: 14 May 2005.

<sup>370</sup> 24 April 2003. Reported by *Interfax Ukraine*.

<sup>371</sup> Wellhausen 2010.

<sup>372</sup> *Ibid.* Workers in foreign firms have more to lose from privatization revision and are more likely to oppose it.

<sup>373</sup> "Yushchenko, Tymoshenko united on reprivatization," *Interfax-Ukraine News Service*: 22 February 2005.

dozen,” then “about twenty” privatizations.<sup>374</sup> Nonetheless, the government never made clear the criteria that would put a privatized asset on the list of firms to be nationalized, nor did it make the list public.

With no clarity as to what it meant for a privatization to be illegal, or how follow-on owners would be held accountable for owning property that was once distributed illegally, foreign firms across the economy felt threats to their contract sanctity.<sup>375</sup> Much FDI entered Ukraine via privatization tenders. When it did not, FDI can often be traced back to privatized assets, through a trail of mergers and acquisitions made over many years, and Tymoshenko’s threats in 2005 implicated privatizations made as long ago as 1992. “Horrorified investors” worried that that broad reprivatization would “send a very bad message that the old government giveth and the new government taketh.”<sup>376</sup> With “the property rights of thousands of enterprises in limbo,” the mechanism of FDI exit and diversion operated across foreign firm national groups.<sup>377</sup> Aggregate FDI was fourteen percent lower in the first six months of the Orange government than it had been under the Kuchma regime a year earlier.<sup>378</sup> When the threat to contract sanctity was perceived as

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<sup>374</sup> “Ukraine to draft ‘exhaustive list’ of companies for reprivatization,” *BBC Monitoring Ukraine and Baltics (Interfax-Ukraine News Agency)*: 15 February 2005. “Yushchenko, Tymoshenko united on reprivatization,” *Interfax-Ukraine News Service*: 22 February 2005. “Ukraine to review privatization of 20 major firms this year: deputy PM,” *Agence France Presse*: 26 February 2005. Yushchenko also clearly alluded to the Yukos takeover in Russia, saying that Ukraine would review privatizations “in a very different way.” “Ukraine’s Yushchenko slaps down PM on privatization threat,” *Agence France Presse*: 18 February 2005.

<sup>375</sup> Interviews, various, Ukraine.

<sup>376</sup> Chazan, Guy. “Kiev’s Orange Revolution is soiled – Ukrainian cronyism scandal, symbolized by steel plant, divides new government,” *The Wall Street Journal Europe*: 12 September 2005. “Q&A with pro-Ukraine investment banker Michael Bleyzer,” *Kyiv Post*: 27 January 2005. Bleyzer explained what he would do regarding reprivatizations: “I would take one or two showcases and review them, trying to be fair and objective. In some cases, getting additional compensation would be sufficient if there is enough assurance that that would have been the market price had the tender been run transparently; in other cases it is possible that re-tendering them would be the option. However, this is a less attractive option, as it will send a very bad message that the old government giveth and the new government taketh. So I would certainly be very careful not to do a lot of those things.”

<sup>377</sup> Aslund, Anders. “Betraying a Revolution,” *The Washington Post*: 18 May 2005.

<sup>378</sup> “Post-revolution Ukraine still awaits business Shangri-la,” *Agence France Presse*: 16 November 2005.

universal, conventional wisdom about FDI exit held true: foreign firms across the whole economy reevaluated their strategies and decreased planned investments, imposing heavy costs on Ukraine's Orange government, which needed tax revenue and economic growth to keep the country afloat and fulfill its development promises.

Although risks to contract sanctity were common across nationalities, investors framed their frustrations in national terms and exercised voice using national resources. For example, in June 2005, Yushchenko reassured Czech investors at a special forum on reprivatization attended by the Czech President Vaclav Klaus. Ukrainian television aired a program on German investors' fears of reprivatization, and then one on British investors' fears.<sup>379</sup> The German and British ambassadors gave independent, public statements demanding protection for their nationals' property; it is reasonable to assume that similar pressure from other diplomatic staff occurred behind the scenes. In July, a US Assistant Secretary of State testified on the threat of reprivatization before the US House of Representatives Committee on International Relations, warning, "mixed signals on the extent of reprivatization have dampened potential investment."<sup>380</sup> The US Assistant Secretary also visited Ukraine and participated in a specially organized group of American firms and diplomats lobbying the Ukrainian government over threats of breach.<sup>381</sup> The US-Ukraine Business Council (USUBC) took a strong stand against reprivatization and

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<sup>379</sup> 24 July 2005, German investor in Ukrainian titanium plant fears reprivatization, *BBC Monitoring Ukraine & Baltics*.

<sup>380</sup> He also drew attention to another contract breach happening simultaneously. Ukraine suddenly eliminated its system of Free Economic Zones, again citing corruption, but the Assistant Secretary pointed out that this damaged American firms that did not misuse FEZs. Unlike the reprivatization issue, however, respondents for this project agreed that the FEZ cancellation did not pass the threshold of government breach of contract for which they would take extraordinary action. See next chapter for a similar example of extra-contractual withdrawal of tax benefits. 30 July 2005, *Ukrainian News*, "US concerned over economic policy of Ukraine." Speech by US Assistant Sec of State Daniel Fried before Committee of International Relations of the US House of Representatives:

<sup>381</sup> Interviews (2), Washington, D.C.

participated in ongoing behind-the-scenes negotiations.<sup>382</sup> British, French, German, and Israeli national investor associations came to imitate the USUBC in the mid to late 2000s, lobbying the Ukrainian government on their investors' behalf.<sup>383</sup> National, rather than multinational, advocates organized and pressured the Ukrainian government to commit to the sanctity of privatization contracts.

One set of co-nationals did interpret reprivatization as a more particular threat directed at their national group. Russian firms account for significant amounts of FDI into large, privatized Ukrainian assets, several of which were sold early in Ukraine's transition under non-transparent circumstances. Russian actors behaved as predicted by the theory here: Russian firms organized along national lines, framed reprivatization as an issue of discrimination against Russian investments, and drew on Russian political and diplomatic support to advocate for their property rights. Though there might have been opportunities to come together with other national investor groups also fearing contract breach, Russian firms and diplomats acted bilaterally. The Russian Duma opened an investigation into the implications of Ukrainian reprivatization for Russian investors the day after Tymoshenko threatened to reprivatize 3000 firms. Duma members claimed that the privatization review was motivated by anti-Russian sentiment and argued that Russia should take steps to defend its interests.<sup>384</sup> In lobbying Russian politicians for support, Russian firms also

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<sup>382</sup> Interview, USUBC, Washington, D.C.

<sup>383</sup> Russian investors have come to benefit from close ties between individual investors, Ukrainian politicians, and the Russian state. The informality of Russian collective action is one reason that Russian-owned firms face different risks to contract sanctity and have access to different sorts of resources to dispute contract breach.

<sup>384</sup> "Russia moves to safeguard interests from Ukraine 'de-privatization'," *Agence France Presse*: 18 February 2005.



framed reprivatization as “very harmful to the interests of Russia.”<sup>385</sup> Russian President Vladimir Putin, together with Russian firms representing a variety of industries, soon met with President Yushchenko, who promised, “nothing will happen to the lawfully acquired assets of Russian oligarchs.”<sup>386</sup> Given the uncertainty over what it meant for a privatization to be lawful, this promise likely did little to assuage Russian concerns.

A reprivatization list was leaked in May 2005, four months after Tymoshenko’s original announcement. This confirmed Russian fears, as four Russian-owned firms, in petrochemicals, steel, mining, and aluminum, were the only foreign firms among the twenty-nine privatized firms listed.<sup>387</sup> In the first major repossession of privatized property, a Ukrainian court ordered the renationalization of a Russian-owned aluminum plant. The head of a powerful Russian association put this action in national terms: “this reprivatization is clearly anti-Russian...We do not hear anything about European or American assets.”<sup>388</sup> Rather than using the worries of investors of other nationalities as a means to support the Russian cause to ensure contract sanctity, key Russian actors framed reprivatization in terms of bilateral animosity between the West-oriented Orange government and Russia.

The difference between Russian-origin and other investors’ perceptions of contract sanctity became clear with the nationalization and reprivatization of Ukraine’s largest steel mill, Kryvorizhstal.<sup>389</sup> In 2004, Kuchma’s government sold the steel mill to prominent

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<sup>385</sup> “Lukoil, TNK-BP, Tatneft, Alliance Group asking Russian Prime Minister Fradkov to protect their interests in Ukraine,” *Ukrainian News*: 19 April 2005.

<sup>386</sup> “The fate of Russian investments in Ukraine.” *Moskovskii Komsomolets*, No. 55: 16 March 2005. “Russian companies in Ukraine are kept on a short leash.” *Vedomosti*: 28 April 2005.

<sup>387</sup> Wilson 2005: p 166.

<sup>388</sup> “Russian companies in Ukraine are kept on a short leash.” *Vedomosti*: 28 April 2005.

<sup>389</sup> The mill’s name was changed shortly thereafter to Kryvyi Rih, but it will be referred to as Kryvorizhstal for the ease of the reader.

Ukrainian oligarchs, investing via Cypriot firms, for US\$800 million, or about half of the high bid of US\$1.5 billion put forth by Mittal Steel.<sup>390</sup> The Orange government repossessed the mill without compensation in 2005, fulfilling a promise that had been part of both Yushchenko's and Tymoshenko's election campaigns.<sup>391</sup> The steel mill was resold in October 2005 in a transparent auction, televised with much fanfare.<sup>392</sup> Mittal Steel offered the unexpectedly high winning bid of US\$4.8 billion.<sup>393</sup>

Russian investors protested this reprivatization, worried that it would lead to more actions against similar, large-scale Russian investments that often involved oligarchs and Cypriot firms. Yanukovych, the leader of the Russian-sympathetic Party of the Regions, argued that the Kryvorizhstal's reprivatization had a "negative effect on the image of Ukraine," and that "any step under this very unpopular word reprivatization will definitely affect the image of Ukraine and push away investors."<sup>394</sup> In contrast, non-Russian executives in Ukraine saw Kryvorizhstal's reprivatization as a signal of a new commitment to transparency and anti-corruption. The publisher of the English-language newspaper of

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<sup>390</sup> Most states, including Ukraine, reserve the right to discriminate against foreign investment at the border. While rejecting Mittal Steel's bid perhaps walks the line of breaching commitments to fair treatment to foreign firms, it thus falls outside of the question considered here – breach of contracts and commitments made to existing foreign firms.

<sup>391</sup> Yushchenko argued that Kryvorizhstal "was not privatization, but the humiliation of honest business; it humiliated the government." "Yushchenko: Reprivatization policy would have discredited new government." *Associated Press Newswires*: 6 October 2005. In a televised presidential debate, Yushchenko said, "When we are divided, the authorities can steal Kryvorizhstal in one night, and we'll have to listen for twelve months the fairy-tales of this government." "Ukrainian presidential candidates clash in TV debate." Translated from Ukrainian by *BBC Summary of World Broadcasts*: 15 November 2004. Source: *UT1* (television station). See also: Aslund, Anders. "Betraying a Revolution," *The Washington Post*: 18 May 2005. "Yushchenko: Reprivatization policy would have discredited new government." *Associated Press Newswires*: 6 October 2005.

<sup>392</sup> "The Great Giveaway Revisited," *Kyiv Post*, 25 September 2008.

<sup>393</sup> The Ukrainian government had hoped to sell Kryvorizhstal for \$2 billion at best; its windfall price gave the government new budgetary breathing room.

<sup>394</sup> "Yanukovych cautions cabinet against reprivatization as it confuses investors," *Ukrainian News*: 24 December 2007.

record in Ukraine gave voice to the distinction non-Russian investors made between Kryvorizhstal and the broader reprivatization threat, writing,

Kryvorizhstal became a symbol of the corruption of Ukraine's old regime... Yushchenko and other speakers made the lucrative steel mill a talking point of the Orange Revolution, promising to right the injustice...After all the controversy over reprivatization this year, the government showed that it has the right values – transparency, honesty, and private enterprise – and that it knows how to do things correctly. Congratulations to Mittal and to the government.<sup>395</sup>

Reflecting back on the reprivatization some years later, foreign executives in Ukraine cited the US\$4.8 billion price as an important beacon for major multinational entrants from Western European countries, which contributed to Ukraine's FDI boom (see Figure 3).<sup>396</sup> In the next years, for example, the Austrian bank Raiffeisen International invested US\$1 billion and the French bank BNP Paribas invested \$360 million.<sup>397</sup> With Mittal Steel's entry and such large, associated investments concentrated in the hands of major Western European multinationals, Ukraine's FDI nationality mix dropped precipitously and remained low relative to the previous trend (see Figure 3).<sup>398</sup>

The decrease in the FDI nationality mix helped to create an environment beneficial to all national groups threatened by broad reprivatization threats, including Russian investors. Now that Kryvorizhstal had been rectified, Yushchenko faced pressure from newly concentrated international actors to stop the reprivatization campaign. Additionally, with new capital to rely on to contribute to the government budget and the Ukrainian economy, Yushchenko's personal motives in supporting limited reprivatization were satisfied. New, major foreign firms were taking a chance on the Ukrainian government's

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<sup>395</sup> Sunden, Jed. "Welcome to Ukraine, Mittal Steel," *Kyiv Post*: 26 October 2005.

<sup>396</sup> Interviews, various, Ukraine.

<sup>397</sup> "2008 Investment Climate Statement – Ukraine." US Department of State.

<sup>398</sup> Mittal Steel made the investment through a German subsidiary, growing the German share of FDI considerably (see below for a consideration of Mittal's multiple nationality claims).

commitment to contract sanctity, and Yushchenko delivered accordingly.<sup>399</sup> One month after Kryvorizhstal, Prime Minister Tymoshenko took steps to nationalize and reprivatize another huge plant in the eastern city of Nikopol. But Tymoshenko was accused of merely transferring the plant from one clan to another without raising more revenue for the state or making the allocation of property rights any more fair.<sup>400</sup> Yushchenko declared that “high officials had begun to direct events in favor of corporate interests” and that “everybody should get lost,” dismissing his cabinet, removing Tymoshenko from office, and ending the Orange government.<sup>401</sup> Yushchenko then canceled all reviews of privatization deals. Three Russian firms particularly benefitted from the abandonment of reprivatization, going by the leaked list. This goes to show that even a national group relatively unsuccessful in its own advocacy can gain contract sanctity as a by-product of an environment with a low FDI nationality mix.

## Offshore incorporation

Kryvorizhstal was, indeed, a foreign-invested enterprise expropriated without compensation. Kryvorizhstal’s ownership exemplified a particular kind of offshore incorporation, known as “round-tripping,” that occurs in a number of emerging economies.

Round-tripping occurs when nationals invest capital in firms incorporated abroad and then

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<sup>399</sup> Yushchenko was known to have a deep commitment to global markets, which he demonstrated while Chairman of the National Bank of Ukraine from 1993 to 1999.

<sup>400</sup> Viktor Pinchuk, previous Kryvorizhstal owner and son-in-law to former president Kuchma, said Tymoshenko’s privatization reviews were “show business, seizing property from the wealthy, and in particular me.” At this time, Tymoshenko also began reprivatizing a chemical-fertilizer plant owned in part by a Western firm, Worldwide Chemical LLC. This fell by the wayside after Tymoshenko was removed as prime minister. Bellaby, Mara D. “Ukrainian tycoon hopes sacking of government will end all attempts to seize his businesses,” *Associated Press Newswires*: 14 September 2005.

<sup>401</sup> Chazan, Guy. “Kiev’s Orange Revolution is soiled – Ukrainian cronyism scandal, symbolized by steel plant, divides new government,” *The Wall Street Journal Europe*: 12 September 2005. Bellaby, Mara D. “Ukrainian tycoon hopes sacking of government will end all attempts to seize his businesses,” *Associated Press Newswires*: 14 September 2005.

reinvest in their countries of national origin.<sup>402</sup> Like Russians and other post-Soviet investors, Ukrainians sometimes use firms incorporated in places like Cyprus or the British Virgin Islands as platforms from which to invest capital in Ukraine. Cyprus is a particularly appealing destination, as incorporating in a European Union member state gives firms easier access to European markets, and Cyprus has a particularly beneficial double taxation treaty as well as a BIT with Ukraine.<sup>403</sup> This means that FDI from Cyprus comes from firms with access to Cypriot legal resources but, in some cases, with ethnic or citizenship ties to Ukraine.<sup>404</sup>

Kryvorizhstal's first owner was a consortium with close ties to the Kuchma administration. Nine major shareholders within the purpose-built Ukrainian Investment and Metallurgical Union (IMU) bought the plant. While firm ownership in the region can be notoriously difficult to trace, several of these shareholders are either incorporated outside of Ukraine, mainly in Cyprus, or have significant (greater than ten percent) ownership shares that come from foreign capital, qualifying them as foreign direct investors.<sup>405</sup> Ultimate control sat with two prominent Ukrainian oligarchs: Viktor Pinchuk, Kuchma's son-in-law, and Rinat Akhmetov, a Kuchma ally. Thus, Kryvorizhstal's original private owners were simultaneously foreign and domestic investors.

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<sup>402</sup> Chinese investors commonly round-trip through Hong Kong; West African investors use Cape Verde among other locations.

<sup>403</sup> Occasionally, Ukraine's Parliament debates whether to annul this treaty, but doing so would not be popular with the domestic business community that enjoys close ties to politicians.

<sup>404</sup> Another subset of FDI is diaspora investment, coming from Ukrainian émigrés reinvesting in Ukraine. This more traditional form of FDI is difficult to distinguish from round-tripped investment.

<sup>405</sup> The nine shareholders were: the Interpipe Corporation and the Nyzhnedniprovsky pipe plant, both controlled by Viktor Pinchuk; two coking and chemical plants (Avdiyivka and Markokhim) owned by System Capital Management, which is controlled by Rinat Akhmetov; the Ukrainian-Cypriot company Bipe Co. Ltd; two banks (Dnipro Bank and Ukrinvest Bank, a part-owner of UkrSibBank); the insurance firm Aura; and the metallurgical combine Azovstal. Pinchuk and Akhmetov are popularly understood to have been Kryvorizhstal's owners. "Cabinet starts to re-privatize Kryvorizhstal," *Business Report Ukraine* (7 February 2005), distributed by *Interfax News Agency*.

While domestic firms are limited in their ability to divest from their country, round-tripped firms have access to exit as well as to some voice resources with which they can fight breach. Round-tripped investors can withdraw funds just as any foreign investor would do, giving them a fundamental source of leverage over host governments interested in access to mobile capital. A cousin of round-tripped firms' ability to exit is their ability to sue an FDI "host" country. Under today's bilateral international property rights regime, round-tripped firms with access to BITs have been able to sue over breach of contract, a right Ukrainian nationals have exercised.<sup>406</sup> However, unlike their traditional counterparts, round-tripped firms do not enjoy the same access to diplomatic support or inter-firm voice resources that other co-national investors do. In Ukraine and elsewhere in the region, there is little evidence that diplomats from Cyprus advocate on behalf of round-tripped firms. Round-tripped firms thus miss out on a major source of external leverage that helps traditional foreign firms tie contract disputes to other bilateral foreign policy issues.

The threat of withdrawing their own capital did Kryvorizhstal's owners little good, as the threat to their contract sanctity was nationalization. As far as voice resources, no international diplomats came to the original owners' aid, nor did foreign investors of Cypriot or other national origins support the Cypriot-Ukrainian owners' protests. This lack

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<sup>406</sup> The case that set the precedent allowing round-tripped firms to access BITs, in fact, was brought against Ukraine: a Lithuanian-incorporated firm, owned by Ukrainian nationals, was allowed to sue the Ukrainian government under the Lithuania-Ukraine BIT in 2004. The Tokios case came about when a Lithuanian-incorporated printing firm, owned by a Ukrainian political refugee, had its Ukrainian accounts frozen and its offices subject to repeated police and tax enforcement raids. This occurred under the Kuchma regime, after the firm printed a book about then-opposition leader Tymoshenko just prior to the 2002 parliamentary elections. Tokios took the case to international arbitration at ICSID, where the arbiters allowed jurisdiction under the Lithuania-Ukraine BIT, writing, "the ICSID Convention contains no inchoate requirement that the investment at issue in a dispute have an international character in which the origin of the capital is decisive." *Tokios Tokeles v. Ukraine (ICSID Case No. ARB/02/18)*, Decision on Jurisdiction, April 29, 2004: Paragraph 82. This right has been challenged in at least one case, as reported in the article, "In unpublished ruling, arbitrators find that Swiss company's ties to Switzerland are too tenuous to deserve protections of investment treaty; one-off cross-border purchase of receivables in Slovak Republic is not a protected investment." *Investment Arbitration Reporter*: 14 April 2011.

of support from other foreign investors came as a surprise to Kryvorizhstal's Cypriot-Ukrainian owners, as made clear in an interview with its most prominent oligarch owner:

(Interviewer) ...[Kryvorizhstal] will be sold in two weeks' time. And your predictions that no one will take part in the privatization are not coming true.

(Pinchuk) Let's look at what will happen on 24 October. It seems to me that the closer it gets to the tender, the more serious investors will start to ponder the situation. ...There have been a whole number of violations around the reprivatization of the combine.

(Interviewer) There is something you're not saying – what might prevent the repeat sale of Kryvorizhstal?

(Pinchuk) The investors must stop and think. Our lawyers have sent the investors a letter describing the situation.

(Interviewer) To all potential investors – Arcelor, Mittal?

(Pinchuk) Yes, all of them! We have set out the current position. The case is at the Supreme Council. Say you want to buy a flat but you are told that this flat is the subject of a court case. Will you risk buying it? I don't think so.<sup>407</sup>

Despite Pinchuk's and other owners' efforts in both the media and legal forums, traditional foreign firms saw Kryvorizhstal as tied up with domestic politics, and Mittal Steel, Arcelor, and other major steel firms vied for the asset freely and without hesitation. Round-tripped firms occupy a hybrid nationality category when it comes to their ability to use their foreign status as a means to constrain a "host" government from violating contract sanctity. Certainly, the risks faced by this hybrid nationality differed from those of "traditional" foreign firms. For Kryvorizhstal's Cypriot-Ukrainian owners, the exit and voice threats their foreignness offered were insufficient to deter breach.

## True multinationals

Some multinationals do have origins in two or more home countries, even after excluding offshore incorporation. The steel giant ArcelorMittal and its subsidiary in

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<sup>407</sup> "Ukrainian top businessmen call for end to reprivatization." Translated by *BBC Monitoring Ukraine & Baltics*. Source: *Ukrayinska Pravda*: 18 October 2005.

Ukraine provide a good example of this. Mittal Steel, a British firm, bought Kryvorizhstal for US\$4.8 billion.<sup>408</sup> That investment was made through a major German subsidiary. Later, Mittal Steel merged with Arcelor, a French firm with strong ties to the French state. By 2011, considerable investment in their Ukrainian subsidiary also came from Luxembourg. Thus, ArcelorMittal's operations in Ukraine have ties to and potential claims on multiple national groups of investors and multiple home governments: France, the United Kingdom, Germany, and Luxembourg.<sup>409</sup> What does this complicated nationality mean for ArcelorMittal's contract sanctity and its ability to ensure its contract sanctity in Ukraine?

On one hand, a firm like ArcelorMittal with multiple home countries is open to more sources of risks to contract sanctity than a traditional, one-home foreign firm, because it is sensitive to political risks emanating from more than one bilateral relationship. This broader exposure to political risks can alienate some of the firm's (various) co-nationals, making them unwilling to participate in collective lobbying efforts if the multiple-home firm's dispute is seen as too far removed from their experience. On the other hand, diplomats from the different home countries retain incentives to support a multiple-home firm, since the presence of multiple homes does not change a diplomat's interest in the fortunes of a firm that provides employment, taxes, and revenues in its home countries. However, if other home country governments will also advocate on the multiple-home firm's behalf, diplomats do have an incentive to free ride on others' efforts. In Ukraine, ArcelorMittal has proven able to counteract diplomats' incentives to free ride, as it has

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<sup>408</sup> Mittal Steel also has an Indian identity, thanks to its owner Lakshmi Mittal's Indian heritage, but it has no legal ties to that country.

<sup>409</sup> Not to mention that Lakshmi Mittal, the owner of Mittal Steel and then CEO of ArcelorMittal, is of Indian heritage. A prominent business journalist attributes Mittal's problems, including violence at the Kryvorizhstal mill, to "xenophobia against Indians." Interview, Ukraine.



received active support from the four home governments on which its Ukrainian operations has claims. Below, I explain how diplomatic support has been consistent, while ArcelorMittal's various co-national firms proved willing to get involved in advocacy efforts around one contract dispute but distanced themselves from another.

### **Co-national lobbying and diplomacy**

Foreign firms have been frustrated by value-added tax (VAT) refunds in Ukraine since the late 1990s, but the government's need for cash during the global financial crisis brought VAT arrears to new heights. In a VAT system, a government refunds VAT to exporters. In many countries, these refunds are simply a matter of accounting, and exporters do not actually advance money in the process. In Ukraine, however, money does change hands, and the government has repeatedly reneged on repayments. ArcelorMittal became, as its Ukrainian director put it, "the outright champion" of VAT arrears.<sup>410</sup> ArcelorMittal did not get VAT refunded from late 2009 to 2010, and it was also asked to pay its income taxes months in advance, leaving it a creditor to the Ukrainian government for US\$500 million by mid 2010. Adding insult to injury was the fact that ArcelorMittal's domestic competitors received regular VAT refunds. ArcelorMittal called attention to this discrepancy in the business press: "We are witnessing the unfair treatment of international investors."<sup>411</sup>

The government's VAT arrears to ArcelorMittal accounted for thirty percent of the US\$1.2 billion in outstanding VAT owed to its exporters by August 2010.<sup>412</sup> The total debt

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<sup>410</sup> Graham Stack. "Value-added tax system provides case study in corruption, favors." *Kyiv Post*: 3 June 2010.

<sup>411</sup> Ibid. These competitors, in fact, do include some round-tripped foreign capital. This goes to show, again, the distinction actors draw between traditional and legally-acquired 'foreignness.'

<sup>412</sup> "State Tax Administration: Value-added tax bonds worth Hr 16 billion ready." *Interfax-Ukraine*: 6 August 2010.

owed by the state to foreign firms, in VAT and advance taxes, was put at over US\$3 billion.<sup>413</sup> Unsurprisingly, other foreign firms to whom VAT was owed advocated for themselves alongside ArcelorMittal. More importantly, a number of non-exporting foreign firms saw ArcelorMittal's VAT problems as a harbinger of threats to their financial relationship with the Ukrainian government: as one executive worried, "there but for the grace of God go we."<sup>414</sup> This common concern allowed ArcelorMittal to assemble effectively multilateral action. With its broad European identity, ArcelorMittal used the European Business Association (EBA) as a lobbying group on its behalf. Though the EBA generally rejects campaigns on behalf of a particular firm, ArcelorMittal's situation touched enough constituencies to overcome the EBA's reluctance. ArcelorMittal also got multilateral players in Ukraine, including the European Bank for Reconstruction and Development, the World Bank, and the International Monetary Fund (IMF), to lobby on its behalf; these organizations will advocate on behalf of contract disputes when pressed by members from several of their national constituencies.<sup>415</sup> As a result, Ukraine's 2009 IMF package included an uncharacteristically specific stipulation about VAT repayment; in 2010, the Ukrainian government acknowledged that non-refund of VAT "negatively impact[ed] Ukraine's difficult talks with the IMF."<sup>416</sup>

Home governments' pressure, however, may have made the difference in pushing the Ukrainian government to settle with ArcelorMittal. The British Embassy was a strong advocate.<sup>417</sup> The German embassy was also quite vocal in public and behind closed doors,

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<sup>413</sup> "German investor sues Yanukovich." *Kyiv Post*: 15 July 2010.

<sup>414</sup> Interview, Western firm, Ukraine. Nationality suppressed by request.

<sup>415</sup> Interviews (2), international organizations, Ukraine. For a deeper treatment of the role of international organizations in contract disputes, see chapter 6.

<sup>416</sup> Graham Stack. "Value-added tax system provides case study in corruption, favors." *Kyiv Post*: 3 June 2010.

<sup>417</sup> Interviews (2), British firms, Ukraine.

providing evidence that ArcelorMittal's use of a German subsidiary did indeed carry with it access to resources reserved for German firms.<sup>418</sup> French President Nicolas Sarkozy intervened directly during President Yanukovich's state visit to France in 2010.<sup>419</sup> Shortly after that visit, the Ukrainian government offered and ArcelorMittal accepted US\$215 million of discounted VAT treasury bonds.<sup>420</sup> It took until 2011 for the VAT issue to be wholly settled, which ArcelorMittal confirmed only after the Ukrainian Premier met with the Head of the Parliament of Luxembourg.<sup>421</sup> Another of ArcelorMittal's home countries joined its many co-national firms and home country diplomats in successfully advocating on the firm's behalf.

### **Diplomacy only**

As the owner of Ukraine's largest steel mill, ArcelorMittal's assets in Ukraine are effectively immobile. Immobile investors are thought to be subject to an "obsolescing bargain," whereby the host government gains leverage to break contracts with firms that have lost the credible threat of exit.<sup>422</sup> The Ukrainian government has an ongoing interest in ArcelorMittal's operations as the firm employs over 50,000 people; it operates an asset with a social history that gives the firm a prominent place in Ukrainian politics; and it is the biggest economic player in one of Ukraine's less-developed regions. With little chance of exit and disproportionate attention from the government, the obsolescing bargain logic

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<sup>418</sup> Graham Stack. "Value-added tax system provides case study in corruption, favors." *Kyiv Post*: 3 June 2010.

<sup>419</sup> Vlad Lavrov. "ArcelorMittal becomes target after complaining about taxes." *Kyiv Post*: 25 February 2011. Following that, ArcelorMittal CEO Lakshmi Mittal came to Ukraine and held a three-hour meeting with Yanukovich.

<sup>420</sup> "State Tax Administration: Value-added tax bonds worth Hr 16 billion ready." *Interfax-Ukraine/Kyiv Post*: 6 August 2010. ArcelorMittal was willing to accept the losses the bonds entailed: "Understanding the challenging situation the Ukrainian government is facing with VAT refunds, we have accepted that issuing the VAT T-bonds was a controversial but necessary compromise decision." "ArcelorMittal Kryviy Rih reports receiving VAT bonds worth Hr 1.7 billion from the state." *Kyiv Post*: 8 September 2010.

<sup>421</sup> "Government: VAT reimbursement to ArcelorMittal Kryviy Rih settled." *Interfax-Ukraine*: 3 March 2011.

<sup>422</sup> Vernon 1971.

suggests that ArcelorMittal should face breach of contract, and, indeed, ArcelorMittal has faced threats to its contract sanctity in addition to the VAT arrears breach. But ArcelorMittal's experience demonstrates that firms in vulnerable industries need not forego diplomatic support – even diplomatic support coming from a variety of home countries, none of which has total claim on the firm and each of which could free ride on the others. In ArcelorMittal's more industry-specific contract disputes, however, other firms sharing ArcelorMittal's nationalities were unwilling to participate in collective action, as their sense of shared contract risks was weak.

From 2007 to 2009, the Ukrainian government threatened to nationalize Kryvorizhstal a second time. The threats were couched in a series of regulatory rationales contesting ArcelorMittal's follow through on local development clauses written into the privatization agreement. At their core, however, these threats were a product of party politics. The head of the State Property Fund (SPF), the department responsible for Kryvorizhstal's sale to ArcelorMittal, was also the head of the Socialist Party. While the Socialist Party had been part of the Orange coalition in 2005, it afterward aligned with the eastern-looking Party of the Regions, the party that lost out in the Orange Revolution and was unsupportive of Kryvorizhstal's reprivatization.<sup>423</sup> Under Socialist Party leadership, the SPF repeatedly threatened to renationalize Kryvorizhstal, alleging that ArcelorMittal had failed to fulfill contractual clauses on maintaining salary levels and upgrading environmental and social services. Tymoshenko, now in the opposition, called the SPF's threats against ArcelorMittal “groundless and provocative” and led attempts to fire the

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<sup>423</sup> In 2008, even the Chair of the trade union committee of ArcelorMittal Kryviy Rih said that the investment should not be turned into “a pedestal for politicians...Somebody's fingerprints are seen in the situation.” *Interfax Ukraine Business Weekly*: 22 July 2008.

SPF's head.<sup>424</sup> In 2009, Parliament did remove the leader of the SPF and replaced her with a politician loyal to Tymoshenko. The new SPF confirmed that ArcelorMittal had fulfilled all investment obligations.<sup>425</sup> Respondents with close ties to top Ukrainian politicians were confident that behind-the-scenes diplomatic pressure on ArcelorMittal's behalf contributed to Tymoshenko's efforts to replace the head of the SPF.<sup>426</sup>

Nevertheless, the Party of the Regions-led government opened criminal cases against ArcelorMittal in 2010, accusing the firm of smuggling high-grade coal under low-grade customs codes. For ArcelorMittal to have done this would be logistically difficult, given the highly standardized (and physically enormous) coal shipments to its mill and the fact that the regional coalmines only provide certain qualities of coal.<sup>427</sup> This left local observers certain that domestic interests, still desirous of renationalization, lay behind the cases.<sup>428</sup> Home governments again advocated on ArcelorMittal's behalf. Diplomats from Luxembourg and France publicly demanded that Ukraine withdraw the cases. These demands seem to have had a direct effect on Ukraine's behavior. In a press conference after meeting with French President Sarkozy, Yanukovich said that the newly raised question of the state nationalizing Kryvorizhstal "will most likely not reach court." The Ukrainian government soon dropped the criminal cases.<sup>429</sup>

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<sup>424</sup> Ibid.

<sup>425</sup> "Business Briefs." *Kyiv Post*: 11 March 2009.

<sup>426</sup> Interviews, Ukraine.

<sup>427</sup> Interviews (4), legal professionals, Ukraine.

<sup>428</sup> For its part, ArcelorMittal released this statement: "ArcelorMittal Kryviy Rih is supplying coal to Ukraine via big international trader on a long-term contract. We have already made supplies according to this contract this year, previous supplies were cleared by the Customs service without any remarks. We have not changed supplier or coal grade since then. We strongly reject any accusations and have already communicated all proofs of this to the customs." "Customs service opens smuggling case against ArcelorMittal Kryviy Rih." *Kyiv Post*: 15 September 2010. "Is Ukraine's Biggest Foreign Investor Now Safe?" *Kyiv Post*: 13 October 2010.

<sup>429</sup> "Is Ukraine's Biggest Foreign Investor Now Safe?" *Kyiv Post*: 13 October 2010.

The firms that had lobbied on ArcelorMittal's behalf when it came to VAT arrears distanced themselves from these other, acrimonious disputes. For example, national investor associations did not speak out on ArcelorMittal's behalf, nor did the EBA. In general, foreign executives were privately sympathetic to ArcelorMittal, though one prominent executive chastised ArcelorMittal for being "very arrogant" in its dealing with the government.<sup>430</sup> Yet top executives, at firms in a variety of industries and of a variety of nationalities, universally balked at the idea of getting publicly involved in these disputes.<sup>431</sup> While VAT arrears suggested shared risks to breach of tax contracts, an issue relevant to all industries, these disputes were viewed as industry-specific. Interviewees' responses to ArcelorMittal's conflicts suggest that foreign firms have the capacity to hold nuanced and differential understandings of co-national contract risks as separate from risks emanating from industry and asset immobility.

Commonalities created by co-nationality were not enough to spur collective action among firms divided by threats of breach perceived as tied to ArcelorMittal's industry. Yet even when industry considerations made co-national firms act indifferent to breach, home country diplomats still had and acted on incentives to come to the vulnerable investor's aid.

## **Conclusion**

How do foreign firms protect themselves when host governments threaten to break contracts? Investor experiences in Ukraine show that support from home country diplomats as well as coordinated lobbying among co-national firms have been important

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<sup>430</sup> Interview, American firm, Ukraine.

<sup>431</sup> No other steel firms were interviewed, but there is no public support recorded in local or expatriate-marketed media. Interviews, various, Ukraine.

deterrents of breach of contract and means of achieving restitution. Moreover, co-national voice has been useful even when risks to contract sanctity are not clearly divided by nationality or when other characteristics, like multi-nationality or industry, differentiate the political risks facing co-national firms. In short, the experiences of foreign firms in Ukraine over the last years suggest strongly that investors can and do turn to voice resources to preserve contract sanctity and that these resources are filtered by nationality.

The success and failure of foreign firm voice depends not only on the advocacy itself but also on the FDI environment in which co-national actors undertake their campaigns. The entry and exit of national groups of foreign firms in Ukraine has changed the extent to which any one national group's voice presages costs sufficiently high to deter government breach of contract. With more investor nationalities at play through the late 1990s and early 2000s, the Ukrainian government had more room to undercut one group's contract sanctity without damaging its relations with other national groups. When fewer nationalities came to dominate the FDI environment in Ukraine after 2005, breach of contract proved a greater threat to the government's current and future access to FDI, enabling foreign firms to be more successful in deterring breach. The ebb and flow of global capital has created political risks for foreign firms in Ukraine while changing the government's ability to act in ways contrary to foreign firms' preferences and property.

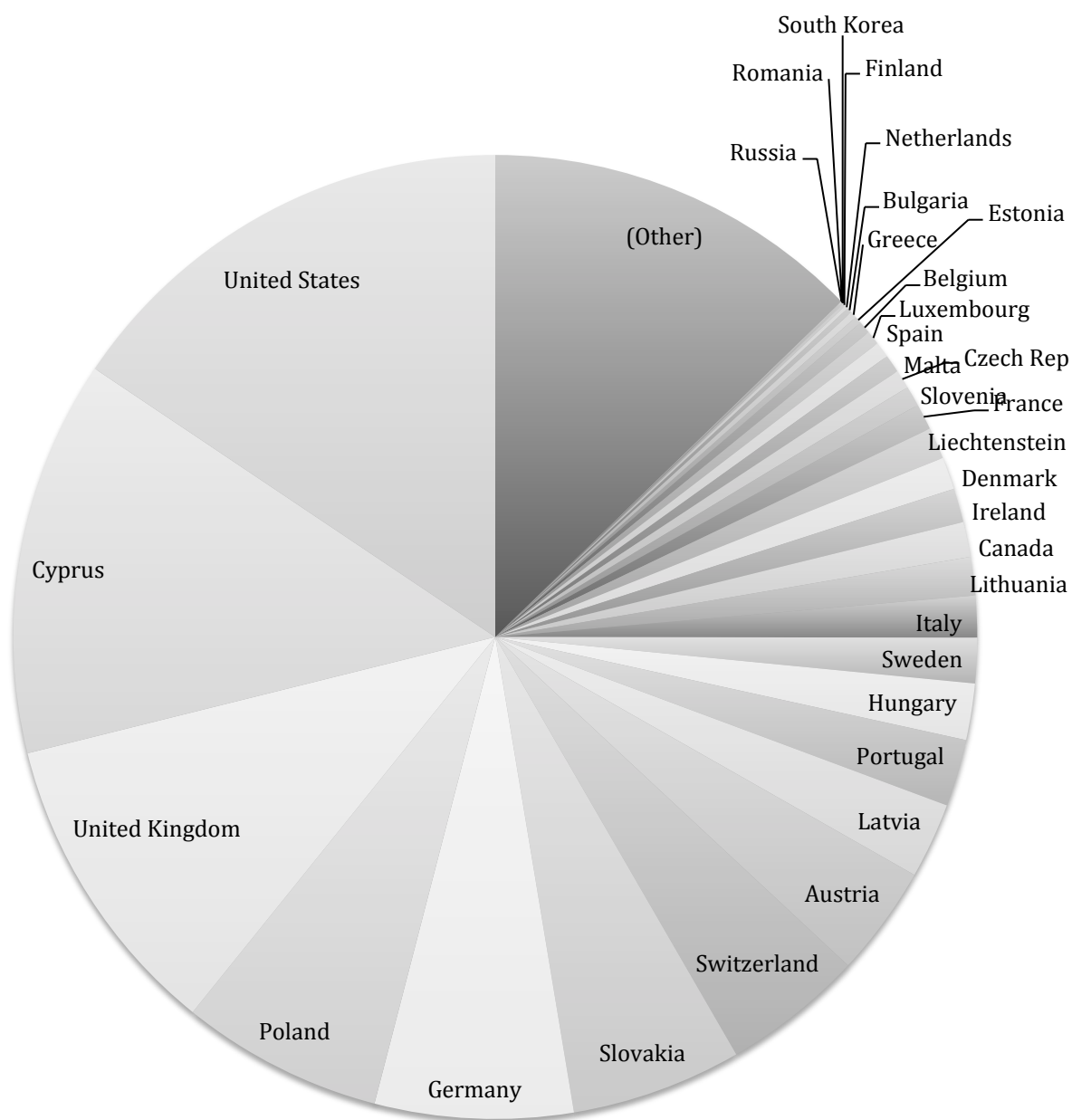
## Figures and Tables

**Table 1. Summary of contract disputes between Ukrainian government and foreign firms, as discussed in the text.**

<b>FDI nationality mix</b>	<b>Year</b>	<b>Case</b>	<b>Nationality</b>	<b>Diplomacy</b>	<b>Co-national lobbying</b>	<b>Outcome</b>
High	1997-1999	Twelve firms	American	Weak	Weak	Breach
	2004	OPIC	American	None	None	Breach
	Early 2005	Kryvorizhstal	Cypriot	None	None	Breach
Declining	2005	Reprivatization	(all)	Strong	Strong	Deterrence
	2005	Reprivatization	Russian	Strong	Strong	Deterrence
Low	2005-2009	OPIC	American	Strong	Strong	Restitution
	2005-2009	Telenor	Norwegian	Strong	Strong	Deterrence
	2007-2009	ArcelorMittal: VAT	Multiple	Strong	Strong	Restitution
	2006-2010	ArcelorMittal: Regulatory	Multiple	Strong	None	Deterrence

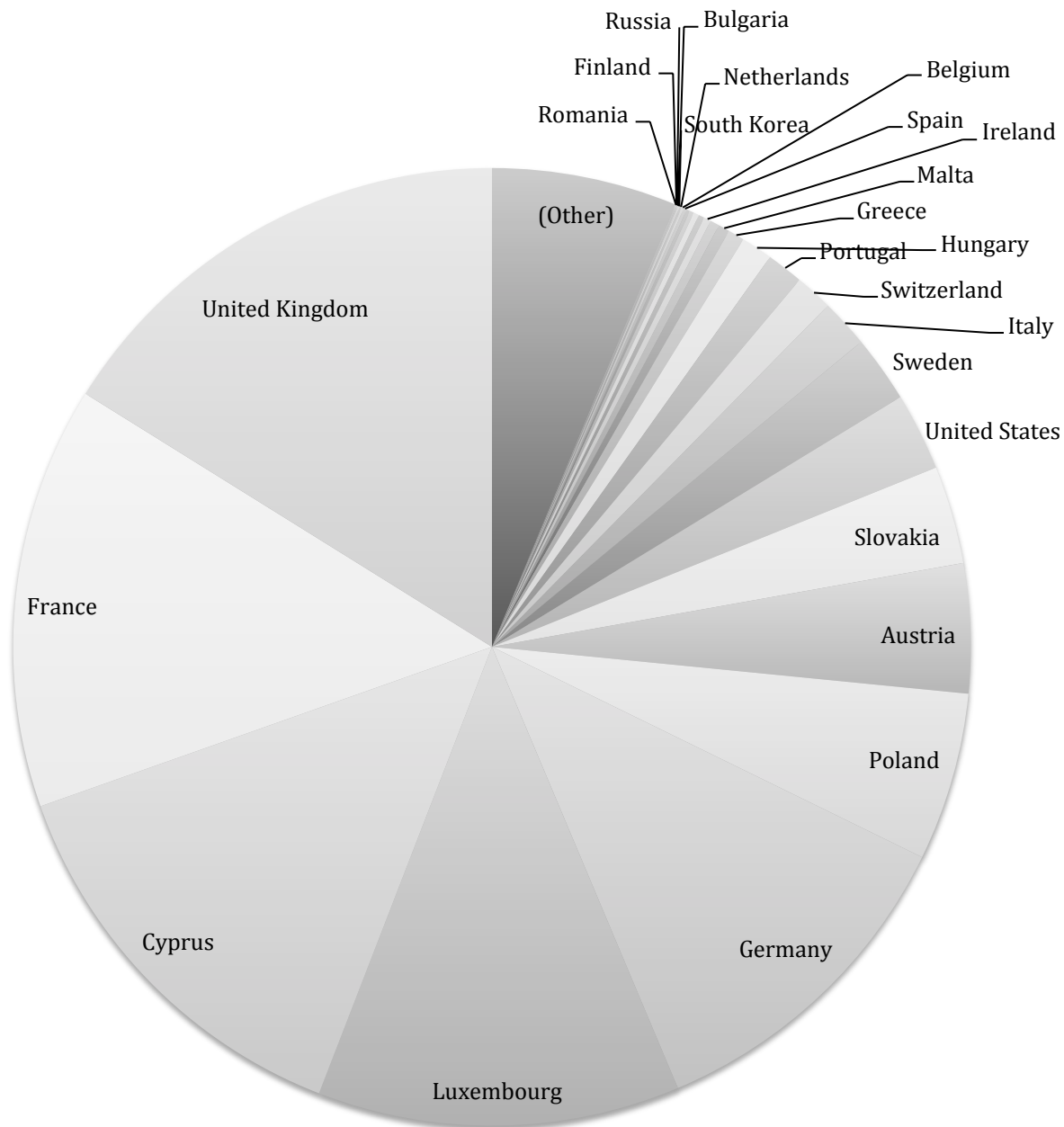


**Figure 1. FDI nationality distribution in Ukraine (2003)**



*Source:* Vienna Institute for International Economic Studies (WIIW), Database on Foreign Direct Investment in Central, East, and Southeast Europe, 2009 Release.

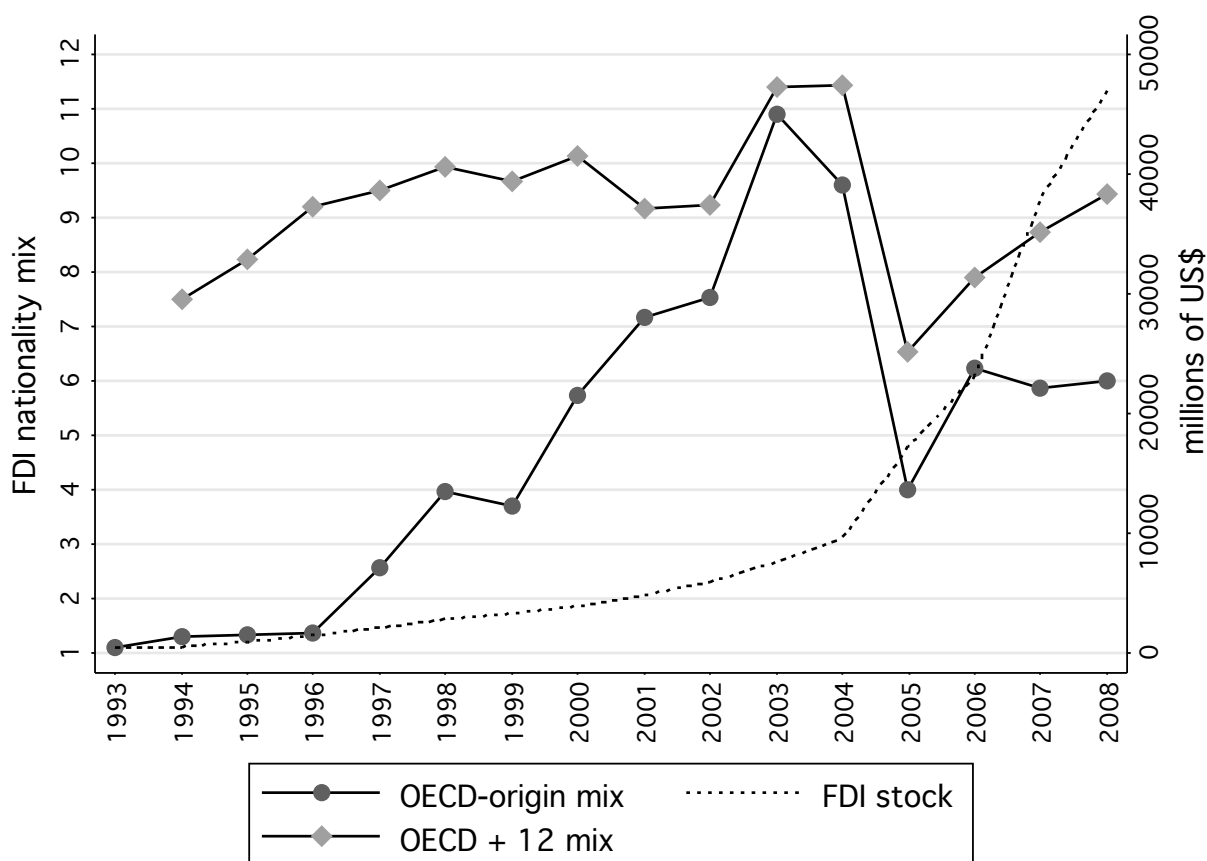
**Figure 2. FDI nationality distribution in Ukraine (2008)**



\$4.8 billion in FDI invested by ArcelorMittal is attributed to the four countries on which the subsidiary in Ukraine has claims: Germany, France, United Kingdom, and Luxembourg. See text for discussion.

*Source:* Vienna Institute for International Economic Studies (WIIW), Database on Foreign Direct Investment in Central, East, and Southeast Europe, 2009 Release.

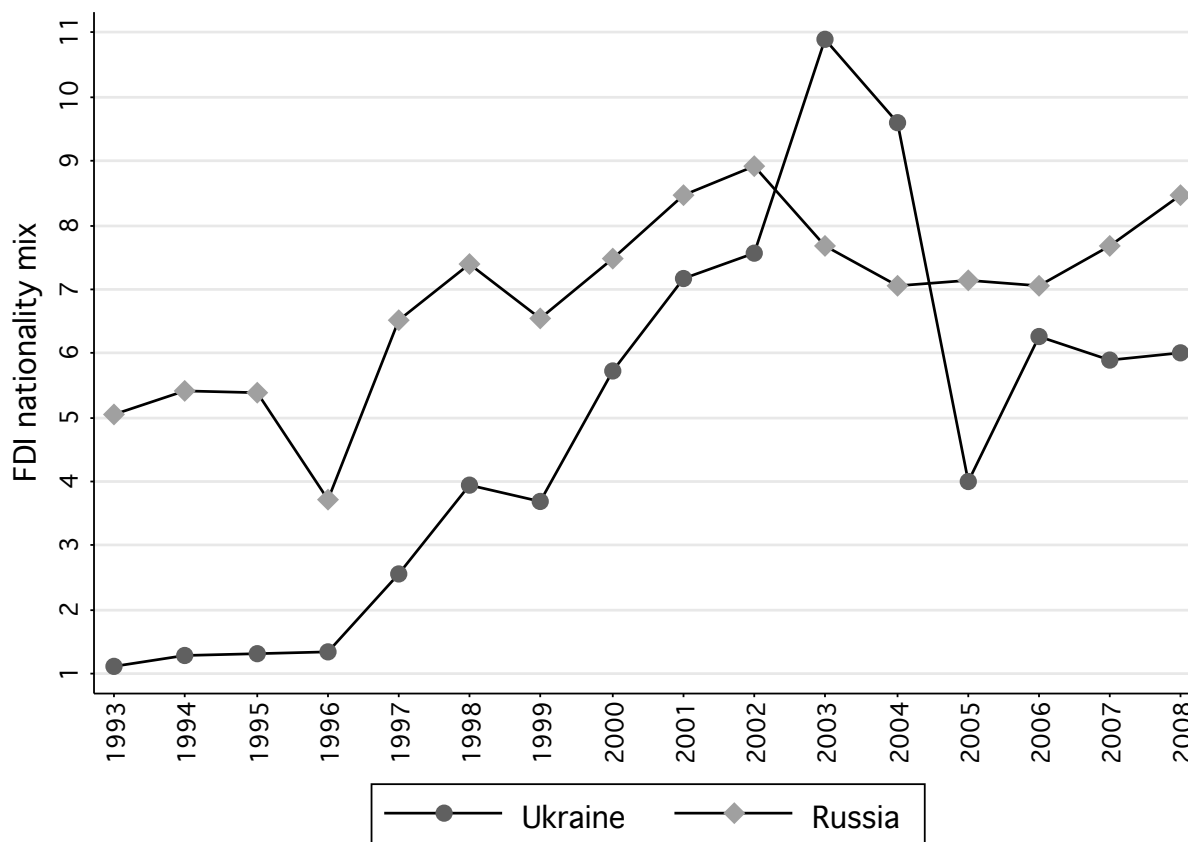
**Figure 3. FDI nationality mix and FDI stock in Ukraine (1993-2008)**



Components of OECD-origin mix	Additional components in OECD + 12 mix
Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Switzerland, Turkey, United Kingdom, United States	Bulgaria, Canada, Cyprus, Estonia, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Romania, Russia, Sweden (omitted: Norway, Iceland)

*Sources:* Organization for Economic Cooperation and Development (OECD), FDI positions abroad. Vienna Institute for International Economic Studies (WIIW), Database on Foreign Direct Investment in Central, East, and Southeast Europe, 2009 Release. World Bank World Development Indicators.

**Figure 4. FDI nationality mix in Russia and Ukraine (1993-2008)**



FDI nationality mix =  $1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ . See chapter 4 for details.

*Source:* Organization for Economic Cooperation and Development (OECD), FDI positions abroad.

## **Chapter 6: Sanctity and Breach in Moldova and Romania**

Moldova and Romania are two emerging economies at very different levels of development and subject to different institutional constraints: Moldova, the poorest country in Europe, has strong informal ties to Russia, while Romania is a member of the European Union. Since independence, the Moldovan economy has had a consistently low FDI nationality mix despite increasing FDI stock. In these conditions, foreign firms have acted successfully to deter expropriation, though corruption remains a problem for both domestic and foreign business in the country. In contrast, the FDI nationality mix in Romania grew quickly to a high level, providing the Romanian government more space to trade off foreign firms' contract sanctity in favor of electoral and other domestic gains. Additionally, breach of contract in Romania has garnered international support, as some of Romania's contracts have conflicted with its commitments to multilateral institutions like the European Union. Although conventional wisdom would posit that Romania in the 2000s is more "foreign investor friendly" than Moldova, variation in the set of foreign investors present in each economy helps to explain the presence of acrimonious, outright expropriation in Romania but not in Moldova. Foreign firm contract sanctity is not necessarily compatible with international mandates, nor is it necessarily impossible in a country known for weak corruption and rule of law.

In this chapter, I first describe the FDI nationality mix in Moldova and Romania. I then compare foreign firms' contract sanctity in the two countries, drawing on some 50 interviews with the local heads of multinational subsidiaries in Moldova and Romania as well as with local representatives of international organizations. Further evidence comes

from interviews with international legal professionals and executives at multinational headquarters in Germany and the United States. In Moldova's environment of a low FDI nationality mix, robust co-national groups have successfully helped to defuse investor-government conflicts and maintain investors' ability to operate in the country. In contrast, a high FDI nationality mix in Romania helps to explain weak co-national associations and the presence of repeated, public, high-profile instances of government breach of contract (see Table 1 for a summary of disputes discussed).

## **FDI nationality mix in Moldova and Romania**

### **Moldova**

Moldova was one of the most "sovietized of the Soviet republics," populated by the Moldovan people who, thanks to Soviet nationality engineering, were made distinct from Romanians and the Romanian state of which they had historically been a part.<sup>432</sup> An independent country since 1991, Moldova at first had a relatively competitive political scene, but not because of a vibrant civil society or democratic leadership. Rather, incumbents in Moldova were unable to concentrate political control through force or via elections, resulting in "pluralism by default."<sup>433</sup> In the 2000s, Moldovan elites were better able to consolidate power: the Communist Party won 70 percent of seats in Parliament in 2001, and President Vladimir Voronin came to power alongside a healthy Communist Party majority that stayed in power through 2009. In that year, an inspired opposition stood together in protests that made international news, but signs of a stable democratic turn-

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<sup>432</sup> King 2000. Today, there is little public support for reunification with Romania.

<sup>433</sup> Way 2005: 232.

around in Moldovan politics only began to appear in 2012.<sup>434</sup> Throughout Moldova's short history, corruption and insider dealing have marked the political scene.<sup>435</sup> Part of the problem is the stagnant conflict with Transnistria (Pridnestrovie), a breakaway region that engaged in a military conflict with Moldova in 1992 and has since been home to Russian troops and a murky gray economy.

Moldova as a whole has considerable economic woes. Economic growth has been positive since 2000, reaching 7.8 percent in 2008 before turning negative in 2009 during the global recession. But the country has been the poorest in Europe. In the late 2000s, its GDP per capita was on par with Senegal and Cote d'Ivoire. A landlocked country without significant natural resources, Moldova depends heavily on agriculture and hopes to continue upgrading its Soviet era industrial infrastructure. The country averaged over US\$250 million in official development assistance and aid annually in the second half of the 2000s, which is more than it receives in FDI.<sup>436</sup>

Nevertheless, FDI has flowed into Moldova since its independence, with gradual growth in annual inflows until 2004 and then quick growth from 2004 to 2008 (see Figure 1). FDI inflows plummeted in 2009, attributable to the global financial crisis and changes in investors' home economies more than any particular change in Moldova's (or any other emerging economy's) situation. Yet inflows were already rebounding in 2010. Annual FDI inflows have been an important part of Moldova's economy, accounting for well over 10 percent of GDP during their peak in 2006 to 2008 (see again Figure 1). External sources of finance have been key to modernization in Moldova's agricultural sector as well as efforts

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<sup>434</sup> The Parliament could not agree on a president, so interim presidents served for three years. Finally, a president was elected (with one vote to spare) in March 2012.

<sup>435</sup> In 2011, Transparency International ranked Moldova 105 of 178 countries.

<sup>436</sup> World Bank *World Development Indicators*.

to upgrade infrastructure and some of Moldova's Soviet-era manufacturing capacity. Annual FDI in fixed capital has grown over 14 times from 2000 to 2010.<sup>437</sup> FDI in Moldova is thinner than in neighboring Romania or Ukraine, as foreign buyers tend to be interested in only the top three or so firms in any given industry.<sup>438</sup> Nevertheless, new buyers have entered. For instance, in 2003 the Turkish Efes Beverage Company bought a major brewery in a public tender set up by an American private equity firm, Horizon Capital. Horizon Capital also facilitated the 2009 sale of a major Soviet-era state bank, Moldova's Agroimbank, to a Slovenian investor via the Moldovan stock market. Local observers attribute the quick growth of FDI inflows in the mid 2000s to bets on Romania and Bulgaria's accession to the European Union (EU) in 2007. With Romania's membership, Moldova now sits on the EU's border and benefits from investors seeking an export platform into the EU. Its cheap labor is more attractive, too, as wages rise in the new EU countries.<sup>439</sup>

The Moldova investment promotion agency printed on the front page of a 2009 "Why Invest in Moldova?" leaflet that "companies from 86 countries have invested in Moldova."<sup>440</sup> There is no evidence suggesting this is the case. Instead, despite growth in FDI, Moldova has seen minimal diversification in the home countries of foreign firms, and it has minimal exposure to OECD investors compared to Romania and other countries in the region. Through the 1990s, Moldova's major foreign investor was the country that was previously a domestic investor: Russia. With the breakup of the Soviet Union, the Moldovan

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<sup>437</sup> National Bureau of Statistics of the Republic of Moldova, Fixed capital investments tables. <http://statbank.statistica.md/pxweb/Database/>. Accessed March 2012.

<sup>438</sup> Interview, foreign firm in financial services, Moldova.

<sup>439</sup> Ibid.

<sup>440</sup> Moldova Investment and Export Promotion Organization (MIEPO), Foreign Investment Guide, *Why Invest in Moldova?* April 2009.



state took ownership over assets within its borders, but Russian actors were quick to reassemble firms and industrial relationships broken by the new international boundaries. For example, Moldovan wine was renowned in the Soviet Union, and Russian capital helped to reorganize the wine industry and grow wine exports to former Soviet states. By 2003, Russian FDI into Moldova accounted for 5.3 percent of total FDI outstock from Russia.<sup>441</sup> In 2009, Russian FDI stock in Moldova reached US\$124.8 million. Another US\$220.9 million in FDI stock originated in Cyprus, a location in which many ethnic Russian (and other post-Soviet) investors domicile their businesses.<sup>442</sup> Russian FDI also effectively sustains the economy in the breakaway Moldovan region of Transnistria, though measuring investment and ownership there is difficult thanks to the region's belligerent relationship with Moldova proper.

Romania has been Moldova's other major source of foreign capital. Romania's economy returned to pre-transition levels only around 2000. In the following years, Moldova became a significant destination for what Romanian outward FDI existed. In 2005, Romania invested US\$19 million in Moldova, accounting for 10 percent of its outward FDI. By 2007, outflows to Moldova grew to US\$51 million, representing some 6 percent of Romanian outward FDI.<sup>443</sup> In 2010, over 475 firms with Romanian capital were operating in Moldova, with the largest investors spread across industries including automotive parts, banking, oil and gas, telecommunications, retail, and manufacturing.<sup>444</sup>

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<sup>441</sup> Moldova Investment and Export Promotion Organization (MIEPO), Foreign Investment Guide, *Foreign Direct Investment*, April 2009.

<sup>442</sup> Moldovan National Bureau of Statistics, June 2010.

<sup>443</sup> *WIIW Database on Foreign Direct Investment in Central, East, and Southeast Europe*, 2009.

<sup>444</sup> "Romania Started to Withdraw Its Capital from Moldova in 2009." *RIA Oreanda-News*: 21 April 2010.

In 1998, the OECD started reporting data on OECD investment into Moldova. France was the first to register FDI into Moldova, and French investors continue to be a visible force in Moldova. In the end of the 2000s, for example, the French mobile phone operator Orange was the largest in Moldova (and maintained a significant presence in Romania), though it had few operations elsewhere in post-Soviet Europe. The Moldovan language, which is essentially the same as Romanian, is a Romance language; this link has facilitated not only French but also a large amount of Italian interest in the country.<sup>445</sup> Post-communist OECD countries, particularly Hungary and Slovenia, are also responsible for investment in Moldova. Entry by a few other nationalities of OECD investors have led to a slight rise in the FDI nationality mix originating from the OECD over the 2000s (see Figure 3), and local government and business actors agreed that the prominence of FDI originating from Russia and Romania is declining. However, Moldova's FDI nationality mix is still far below that of its neighbor Romania (see again Figure 3).

The theory presented in this dissertation therefore predicts that government breach of contract should be less of an issue, and more easily deterred, in Moldova as compared to Romania. If we surmise that a resource-poor less developed country, with a weak democracy and endemic corruption, is likely to have a high incidence of government breach of contract, Moldova proves a strongly counterintuitive case.<sup>446</sup> Co-national investor groups and their diplomatic supporters should be powerful in Moldova, and the government's reliance on few sources of capital should give it pause in considering breach of contract with foreign firms.

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<sup>445</sup> Interviews (4), Moldova Investment and Export Promotion Organization and Italian-Moldova Chamber of Commerce, Moldova.

<sup>446</sup> See chapter 2 for the origins of these hypotheses in literature on foreign direct investment.

## Romania

The dictator Nicolae Ceausescu and his wife were executed on Romanian television on December 25, 1989. With that violent act, the communist regime ended and Romania began its transition to democracy and a market economy. Ceausescu dedicated huge portions of Romania's GDP to repaying the country's foreign debt, which, while impoverishing the country, left it nearly debt free in 1990. Nevertheless, Romania had a particularly difficult transition period in the 1990s and only returned to 1989 GDP levels in 2000. Since then, the economy has grown and structural reform progressed enough so that, while Romania missed out on the first expansion of the European Union in 2004, it and its neighbor Bulgaria became members in 2007. Romania has gas and oil reserves in the Black Sea, but on the whole it remains an agriculturally intensive economy with growth in manufacturing exports.

The first FDI to enter democratic Romania came from Germany, Italy, and France. New entrants from these countries followed a pattern: large firms invested, like France's Renault, and their home country banks came next, like France's Societe Generale.<sup>447</sup> More and more OECD-origin investors added to the mix as the decade progressed and Romania privatized more and more large assets to foreign interests. Neighboring Hungary and Poland were both transition success stories, as signaled by their entry to the European Union in the first wave of expansion in 2004. Their nationals had already begun to invest in Romania in the years leading up to EU entry. Sitting just outside the expanded EU, Romania was host to FDI using the country as an export platform to the EU; firms also sought the cheaper labor and inputs available outside of EU borders. By 2005, more FDI began to flow

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<sup>447</sup> Interviews (3), foreign firms in financial and business services, Romania.

into new, greenfield investments than into privatizations of state-owned property to foreign investors.<sup>448</sup> For example, multinational corporations like Siemens and Hewlett-Packard built much lauded and well-respected plants in the country.

Romania is not considered a transition success on par with its Central European neighbors. Judicial corruption remains a problem in Romania, for example. In part due to corruption, the European Union stalled Romania's (and Bulgaria's) entry to the EU until January 2007. Nevertheless, the reforms Romania undertook in its efforts to join the EU made it a more attractive destination for investment. FDI inflows continued to be high in 2008 but dropped off with the world financial crisis in 2009 (see Figure 2). As shown in Figure 3, the FDI nationality mix in Romania remained stable at a high level in the 2000s as foreign firms from a great variety of OECD countries invested and reinvested.<sup>449</sup> Romania's investment promotion agency, for example, highlights 33 successful large projects (EUR 3 to 450 million) in Romania coming from thirteen home countries in the period 2004 to 2010.<sup>450</sup>

Compared to Moldova, Romania is a wealthy country, with a GDP per capita of US\$12,300 in 2011 as compared to Moldova's US\$3,400.<sup>451</sup> Romania also has deep institutional ties to OECD countries. These factors might suggest that Romania is less likely to break contracts with foreign firms. Nevertheless, the theory presented in this dissertation predicts that in a country with a high and growing FDI nationality mix, the

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<sup>448</sup> Interview, Romanian government official, Romania.

<sup>449</sup> The FDI nationality mix dropped off in 2009, thanks to the exogenous shock of the worldwide financial crisis.

<sup>450</sup> The home countries are: France, Spain, Austria, Italy, Germany, Japan, United States, Portugal, Greece, China, Tunisia, Sweden, and Belgium. Romania Trade & Invest. <http://www.romtradeinvest.ro/>. Accessed March 2012.

<sup>451</sup> Nevertheless, FDI have played proportionally similar roles in each country's economy, with FDI inflows accounting for between 5 and 10 percent of GDP in each country in the mid 2000s. See Figures 1 and 2.

government is increasingly prone to break contracts with foreign firms. The nationality diversity of firms in Romania is expected to undermine solidarity among co-national firms as well as undermine incentives for diplomatic efforts on behalf of broken contracts, enabling more government breach of contract than in Moldova.

Whatever their predispositions to breach, governments in both countries have unsurprisingly used rhetoric assuring foreign firms that their rights are secure. In Moldova, the nascent investment promotion agency publishes literature that assures readers,

The Constitution of the country guarantees the inviolability of both foreign and domestic investors by incorporating principles protecting the supremacy of international law, the market economy, private property, provisions against unjust expropriation, provisions against confiscation of property, and separation of power among government branches.<sup>452</sup>

In Romania, the focus on contract sanctity is less direct but still written between the lines. Romania's investment promotion agency prominently advertises the country's BITs and healthy diplomatic relations, and, in their 2012 promotional materials, the Prime Minister wrote:

I personally want to assure you that you will find here the necessary ingredients for a successful business: an effective and efficient legislative framework, stability, predictability, and resourcefulness...Take advantage of this European opportunity.<sup>453</sup>

Despite Romania's emphasis on the dependability of being "European," Moldova's lower FDI nationality mix coexisted with a stronger government commitment to foreign firm contracts than in Romania.

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<sup>452</sup> Moldova Investment and Export Promotion Organization (MIEPO), Foreign Investment Guide, *Why Invest in Moldova?* April 2009.

<sup>453</sup> "Romania: A European Opportunity for your Investment Projects." Brochure from Romania Trade & Invest, 2012.

## **Sanctity in Moldova**

The first thing one is reminded of when speaking to foreign executives, local government officials, or representatives from multilateral institutions in Moldova is that “this is a small country.” Some emphasize the upside that Moldova’s small size helps foreign firms keep up with business-government relations in Moldova. Moldova’s small, albeit increasing, population of foreign investors is close knit; networking and gossip help information spread quickly. Moreover, the number of investor nationalities represented in Moldova is comparatively low. If there were a set of foreign investors in the world that could form a unified bloc, able to collectively advocate for their contract sanctity, the set in Moldova would be a good candidate. However, as predicted, cross-national advocacy on issues of contract breach is absent in Moldova. Instead, nationality-based foreign investor groups are strong and relevant in Moldova, and action by one of these groups can help to stay the government’s hand when it comes to breach of contract. To antagonize and lose any one of these groups of co-national investors would be costly to Moldova’s FDI-reliant economy. As a result, foreign firms are generally protected from the kinds of breach of contract that domestic firms in Moldova have faced. However, a low FDI nationality mix is not a panacea for all problematic foreign firm-government interactions, particularly when corruption is concerned.

### **Strong co-national solidarity**

As the director of a Western multinational with a significant presence in Moldova put it, foreign firms in the country “have grown to understand the benefit of joining

interests for causes.”<sup>454</sup> But joining interests has occurred on a decidedly national basis: Turkish firms join with Turkish, Russian with Russian, American with American, Italian with Italian. Cross-national support for investor disputes is weak, despite the intimate foreign investor community in the country. Co-national groups benefit or struggle in host government relations differently, due in large part to variation in groups’ cultural and historical bilateral relationships. In an environment with a relatively low FDI nationality mix, firms in co-national groupings have been able to successfully argue their case when engaged in disputes with the Moldovan government.

Turkish investors into Moldova are both welcomed and resented. The Gagauz are an ethnically Turkish minority of less than 200,000 people living in an autonomous region in Moldova. In investment promotion materials in 2008, the Gagauz government advertised that 104 of 6700 enterprises in the region were recipients of FDI. The local government highlights foreign investors from Turkey, with a Turkish-Moldovan textile joint venture serving as the flagship investment in the region.<sup>455</sup> The linguistic and cultural affinities that Turkish investors enjoy in Gagauzia, however, contrast with the racism and sometime violence Turkish people face elsewhere in Moldova. One of the most prominent Turkish executives in Moldova described how Turkish investors use informal ties to each other to mutually navigate both the preferences and animosity associated with their ethnicity. In his opinion, the official Turkish investor association, registered as required with the Moldovan government, puts their ethnicity too much in the foreground.<sup>456</sup> Some executives, Turkish

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<sup>454</sup> Interview, foreign firm in financial services, Moldova.

<sup>455</sup> Munteanu, Igor. “Gagauzia: opportunities for investment,” *Institute for Development and Social Initiatives*, 2008: p 22, 26. Other investors are from Russia, Belarus, and Italy, somewhat similar to the nationality profile in the rest of Moldova.

<sup>456</sup> Interview, Turkish firm, Moldova.

and otherwise, attribute Turkish investors' position with the government to the weak legal constraints Turkey puts on their activities abroad. For example, one Turkish executive willingly admitted to doing "gray things" to earn government officials' trust and support. In contrast to Western executives who shared horror stories in which bribery turned into extortion, this executive characterized "gray" actions as a long-term political risk management strategy.<sup>457</sup> Whether or not all Turkish firms indeed engage in bribery, executives of other nationalities readily associated bribery with the segment of Turkish investors in Moldova. That other foreign firms share this perception of Turkish investors underscores the point that firms of other nationalities see little reason to support Turkish firms in their conflicts with government. Despite their fragile and conflicted reputation in Moldova, Turkish investors have not been involved in a public breach of contract in Moldova as of 2012.

Foreign executives of various nationalities concur that Russian capital in Moldova is "different." Put nicely, one executive said that Russian capital "doesn't require due diligence and transparency in the same way [as Western capital]."<sup>458</sup> In both Moldova and elsewhere in Eastern Europe, Russian investors were associated with rapaciousness in the decade following the fall of the Soviet Union; for example, Russian investors are thought to be more likely to strip assets rather than invest in and rebuild them.<sup>459</sup> At the end of the 2000s, analysts observed that Russian firms are becoming more conventionally oriented toward building robust businesses and making long-term investments. Nevertheless, Russian firms

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<sup>457</sup> Interview, Turkish firm, Moldova.

<sup>458</sup> Interview, foreign firm in financial services, Moldova.

<sup>459</sup> Interviews (2), international organizations, Moldova and Romania.



investing in Eastern Europe maintain a reputation for a high tolerance for risk and for making business decisions other nationalities might not undertake.

In interviews, executives sometimes identified Russian investment in the country as occupying a half-foreign/half-domestic category.<sup>460</sup> Russian investors are the most visible investor group in Moldova, a country in which some 9 percent of the population is ethnic Russian (and another 11 percent is Ukrainian).<sup>461</sup> Unlike in other post-Soviet states, Russian remains a commonly spoken and non-stigmatized language, native to 16 percent of the population and the second language of over 90 percent.<sup>462</sup> As in Ukraine, Russian investors benefit from behind-the-scenes access to political leaders and advocacy from Russian politicians. Both Russian executives and executives of other nationalities observe that informal ties between Moldovan officials and Russian firms matter more to their contract sanctity than any organized investor association. For example, Russian investors do have an officially registered investor association, but the longtime Moldovan President's son Oleg Voronin became its head in 2010.<sup>463</sup> As of 2012, Russian peacekeeping troops remain in Transnistria, the breakaway Moldovan region that has been in a stalemated conflict with Moldova since 1992. Determining the ownership of firms in Transnistria is notoriously difficult, and reliable economic and business data is scarce to non-existent. The common understanding is that formal and informal Russian FDI, in addition to direct subsidies from the Russian government, allows the local economy to function. Non-Russian foreign investors stay away from Transnistria.<sup>464</sup> Both there and in Moldova as a whole,

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<sup>460</sup> Interviews, various, Moldova.

<sup>461</sup> According to the 2004 Moldovan Census.

<sup>462</sup> Ibid.

<sup>463</sup> "Oled Voronin to head Moldovan office of Moscow Entrepreneur Association," *Moldova Azi*: 12 August 2010.

<sup>464</sup> E.g., Interviews (2), development banks, Moldova.

Russian investors face risks and/or privileges common to themselves but separate from investors of other nationalities.

The American Chamber of Commerce in Moldova (AmCham) was founded by an entrepreneurial group of American executives in 2006, and it grew to over 70 members by 2012. Moldova's AmCham focuses on American firms' interests in Moldova, with a clear mission "to promote American trade and investment in Moldova" and an aggressive tagline: "fighting for your business."<sup>465</sup> One fight occurred in 2008, when the Moldovan government threatened to revoke after 15 years what was a 25-year license for an American-owned cable and telecommunications firm to use certain wireless frequencies. According to SunCommunications' 2008 press release, new technologies

make the wireless frequencies extremely valuable. The Ministry of Informational Development announced their intention to take back these frequencies from SunCommunications in order to auction them to new investors in 2009...We believe that the decision...was done incorrectly and that the laws of the Republic of Moldova and international treaties signed by Moldova protect...SunCommunications' investors who have built this business.<sup>466</sup>

Several Central and Eastern European governments have explored revoking telecommunications licenses after having sold them in quick tenders. The Czech Republic, for example, paid US\$353 million in damages to an American investor in a dispute over a decision to reissue licenses, and T-Mobile won a ruling of US\$62 million against state-owned Czech Telecom in 2006.<sup>467</sup> In Moldova, longtime President Voronin and members of his family have extensive investments in the telecommunications sector, and firms in the sector – both domestic and foreign – have expressed frustration with anti-competitive

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<sup>465</sup> See American Chamber of Commerce in Moldova. <http://www.amcham.md/>.

<sup>466</sup> SunCommunications, "The disconnection of the MMDS service." [www.suncommunications.md/](http://www.suncommunications.md/). Accessed March 2012.

<sup>467</sup> See Kerner 2009: 78; Desai and Moel 2008: 239.

behavior.<sup>468</sup> Regardless, non-American foreign firms kept their distance from the dispute. Foreign firms in industries likewise tied up with the Voronin family, including hotels and construction not to mention other telecommunications firms, also stayed away.<sup>469</sup>

Instead, SunCommunications looked to American institutions to put pressure on the government. The AmCham fought for the firm, carrying with it the support of the tightly knit group of American investors in the country.<sup>470</sup> The firm also threatened to access the US-Moldova Bilateral Investment Treaty (BIT), as referenced in the excerpt from their press release quoted above. The firm also highlighted its investors; in the words of an American executive at a different firm in Moldova, “An American investor is well protected by American shareholders; citing them is a good tool.”<sup>471</sup> The exact outcome of the lobbying effort and negotiations with the Moldovan government remains confidential. But, SunCommunications continues to operate in Moldova, has acquired new licenses, and has expanded its business since 2008. American nationality brought with it legal and collective resources that proved sufficient to keep SunCommunications operating and expanding in the country, deterring outright government breach of contract.

American investors enjoy other particular benefits in Moldova that help them sustain contract sanctity. The US Foreign Corrupt Practices Act of 1977 (FCPA) provides credibility to the claim that US firms cannot pay bribes, something executives (American and otherwise) with experience in many countries readily acknowledge. Thanks to this legislative backing, American investors can better avoid going down the rabbit hole

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<sup>468</sup> The threat against SunCommunications’ property likely emerged from both issues of fairness, as in disputes in the Czech Republic and elsewhere in the region, and potential insider benefits from a new auction.

<sup>469</sup> Interview, American firm, Moldova.

<sup>470</sup> The CEO of SunCommunications happened to be the AmCham President, but lobbying decisions are made by a steering committee and require the approval of the membership. There are hints that US diplomats were also involved in the dispute, though this remains confidential.

<sup>471</sup> Interview, American firm, Moldova.

through which a small bribe can give rise to bigger conflicts with government officials and perhaps breach of contract. In the words of one observer in Moldova, with the FCPA “Americans get off the hook, but not French and Germans.”<sup>472</sup> As of 2012 there is no clear and strong anti-corruption legislation to provide a credible commitment for investors from major Continental European countries.<sup>473</sup> American diplomats and executives also note that the US State Department’s Trafficking in Persons (TIP) Report provides a credible threat of US government action that pushes Moldovan officials to respect American interests.<sup>474</sup> As part of the Trafficking Victims Protection Act of 2000, the US government may withhold non-humanitarian, non-trade-related foreign assistance from governments that are categorized as not making “significant efforts” to combat trafficking. The US may also oppose such assistance from the IMF or the World Bank. Moldova, which is a source, waypoint, and destination for much human trafficking in the region, has been on watch for a demotion to this category since the legislation’s inception. Local American actors see positive spillovers from Moldovan relations with American officials over trafficking to Moldovan relations with American business in the country.<sup>475</sup> Institutions like the FCPA and the TIP Report shape the political risks and resources to fight breach that American investors – and not investors of other nationalities – face in Moldova.

Other national groups of investors in Moldova also share relationships with the Moldovan people and government that reinforce co-nationality and not cross-national ties. One prominent Western CEO in the country declares that, in business and politics,

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<sup>472</sup> Interview, international organization representative, Moldova.

<sup>473</sup> The UK Bribery Act of 2010 now provides credibility to British firms’ anti-bribery commitments. It goes farther than the FCPA in that it also prevents payments to government officials in order to speed up bureaucratic processes.

<sup>474</sup> Interview, US government official, Moldova.

<sup>475</sup> Ibid.

“Romanian influence can’t compete with Russian.” Nevertheless, Romanian firms draw on their government’s intimate relations with Moldova when it comes to protecting their property. Italian firms share linguistic affinities with the Romanian/Moldovan language, and Italy has been a migration destination for Moldovan immigrants. The prominent Italian Chamber of Commerce in Moldova cites these characteristics to explain the prominence of Italian investment in the country and the ties between Italian firms and European-oriented parts of the Moldovan government and society.<sup>476</sup> Moldovan diasporans investing from Israel are conscious of domestic conflicts while they also share an ethnic and cultural identity that differentiates their interaction with the Moldovan government from that of other nationalities. Even in the small country of Moldova, foreign firms have cultural, geopolitical, economic, ethnic, and institutional incentives to identify with the political risks of co-nationals while maintaining distance from the problems of firms of other nationalities. But with a small number of national groups accounting for the vast majority of FDI into Moldova, the Moldovan government has a small number of outside options on which to depend should it break contracts with and lose capital from any one national group.

Industry-based organizations are weak among foreign firms in Moldova. Because FDI in Moldova is thin, only a small number of foreign firms participate in any given industry and usually in the biggest and most successful firms in that industry. While this provides the small numbers that might facilitate collective action, it means that foreign firms are each other’s main competitors. Based on foreign executives’ perceptions and the empirical absence of strong industry-based ties, this competition has outweighed the benefits of organization along this cleavage. Further, domestic firms and entrepreneurs in

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<sup>476</sup> Interviews (2), Italian firms, Moldova.

these industries are both competing with existing foreign firms and desirous of finding funding from new foreign firms.<sup>477</sup> This makes for a complicated set of interests that incentivize domestic firms to seek out business partnerships but avoid supporting foreign firms in their disputes with government. In the alcohol and winemaking industries, for example, Russian FDI finds little support from its industry partners. Domestic firms seek capital but avoid entangling themselves in the longstanding Russian-Moldovan conflicts that get played out in this industry, as Russia has on several occasions implemented Moldova-specific health and safety regulations and tariffs.<sup>478</sup> In Moldova, when government-foreign firm disputes arise, neither general foreign investor protest, nor to actions taken by industrial groups, has kept contract sanctity intact; rather, co-nationals' actions have been visible and powerful means to deter breach.

### **Foreign sanctity, domestic breach**

While conflicts have arisen between foreign firms and the government in Moldova, they have been worked out such that even the firm directly involved – such as the American firm SunCommunications discussed above – remains and grows its investments in the country. Another foreign firm in Moldova, the Spanish gas and electricity multinational Union Fenosa, has faced a set of disputes with the Moldovan government that made front-page news. Union Fenosa bought three of Moldova's five distribution companies for US\$25.2 million in 2000 and first turned a profit in 2006.<sup>479</sup> The firm's

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<sup>477</sup> Interviews (6), Moldovan firms, Moldova.

<sup>478</sup> Interviews, international organization representative and Moldovan firm in alcohol industry, Moldova.

<sup>479</sup> "Union Fenosa Moldova Turns to \$8.0 Mln Net Profit in 2006," *SeeNews – South East Europe Newswire*: 6 March 2007.

contract was challenged when the energy regulator lowered the allowable profit margin in 2007.<sup>480</sup> Yet Union Fenosa, too, deterred breach and has grown its investments since then.

Throughout the first decades of economic transition, foreign energy firms in Central and Eastern Europe have had to deal with a legacy of subsidized domestic pricing, combined with monopoly pricing from Russian-origin gas and oil that accounts for the vast majority of supplies. This bind has led to conflicts over foreign energy firms' contracts throughout the region. In Slovakia, for example, the government threatened in 2006 to expropriate Italy's Enel and in 2008 to expropriate the German E.ON should those firms increase energy prices to Slovakian households. These actions were electoral posturing rather than credible threats; no nationalizations were undertaken. Nevertheless, foreign energy executives recognize that such tensions between domestic demands and energy firms' viability inject some level of flexibility into contractual arrangements.<sup>481</sup> In Moldova, Union Fenosa both won and lost in local court cases; but, in the end, the firm found a solution suitable enough to continue and expand their Moldovan investments in the following years.

As predicted by the theory, Union Fenosa had to look to co-national actors for support in its fight; unfortunately for it, Spanish investors are not a visible, powerful group in Moldova.<sup>482</sup> Non-Spanish foreign firms in Moldova "of course" knew about Union Fenosa's dispute, but they maintained their distance. Executives at non-Spanish firms sometimes had personal sympathies for their colleagues at Union Fenosa, but their firms had no incentive to offer public support and risk that the government would make them

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<sup>480</sup> The margin was lowered from 23 percent to 13 percent. "Union Fenosa Moldova To Cut Investments by 30% in 2008," *SeeNews*: 7 October 2007.

<sup>481</sup> Interviews (2), foreign energy firm and domestic energy firm, Cambridge, MA and Romania.

<sup>482</sup> Interviews, various, Moldova.

targets. Nevertheless, causing the exit of a flagship Spanish firm like Union Fenosa would do considerable harm to Moldova's prospects for attracting other Spanish investors. It would also throw the country's electricity distribution system into turmoil.<sup>483</sup> Moldova would likely come to rely on large energy firms from Germany or Austria, already present in neighboring countries. With Spanish investment out of the picture, these new investors could leverage their privileged position against a desperate Moldovan government to extract terms that Moldova might find worse than those with Union Fenosa.<sup>484</sup> The prospect of shutting off doors to channels of investment is a deterrent for governments interested in capital access.

The outcome of negotiations between Union Fenosa and the Moldovan government over possible changes to contractual terms, and the possible involvement of the Spanish government, remains confidential. Nevertheless, Union Fenosa's continued presence and growth in Moldova demonstrates that the Moldovan government stepped back from breach enough to leave the firm's ability to operate in Moldova unchallenged – even as an investor without many in-country allies. In a country with a low FDI nationality mix, and in an industry with a low nationality mix, the government was deterred from violating Union Fenosa's fundamental right to operate.

The absence of fundamental contract breach in SunCommunications' and Union Fenosa's disputes, and the dearth of other, public disputes with foreign firms or instances of actual breach of contract, is most obvious when foreign firms' complaints are contrasted

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<sup>483</sup> This demonstrates a necessary caveat to the literature on the obsolescing bargain, which predicts that immobile assets – like an electricity distribution network – are relatively easily expropriated. In fact, it is not clear that Moldova had the domestic capacity to take over Union Fenosa's operations.

<sup>484</sup> Thinking through this scenario suggests one explanation for why the Moldovan government chose to threaten only creeping expropriation over Union Fenosa's profit margins.



with those of domestic Moldovan firms. Domestic firms' broken contracts have been many and varied. In 2009, for example, the government confiscated a conference center owned by the leader of an opposition party after a court found that there were irregularities in its 1999 privatization; the owner was not invited to the final phase of the trial. The owner of a meat-processing business was thrown into prison for securities law violations, although securities law in Moldova is "non-existent."<sup>485</sup>

The most dramatic instance of government breach of contract with domestic investors has been the Moldovan government's treatment of Moldovan billionaire Anatol Stati. Stati manages a multinational corporation based out of Moldova, the oil services company Ascom. Ascom's primary investments have been oil companies in Kazakhstan, Sudan, the Virgin Islands, and Iraq. Politically, he clashed with Moldova's longtime president, Vladimir Voronin (2001-2009), and Voronin's political allies in the Communist Party. In all likelihood, repeated breach of contract with Ascom over the years has been a form of political confrontation. For example, in 2002, President Voronin annulled an agreement between the Moldovan government and Ascom that, by all respects, seems to have been in Moldova's interests: Moldova would have bought Kazakh gas for 30 percent of the price of Russian gas.<sup>486</sup> Stati claims that the annulment led Moldova to overpay for gas to the tune of US\$1.66 billion.<sup>487</sup> In 2008, Stati's son Gabriel was put on trial in Moldova for hooliganism, and Gabriel spent considerable time in jail. Ascom withdrew its basic staff from Moldova in response.<sup>488</sup>

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<sup>485</sup> "World News: Moldova rulers turn up heat on business." *Financial Times*: 29 May 2009.

<sup>486</sup> Russian gas comes from the Russian multinational Gazprom.

<sup>487</sup> "Moldovan billionaire sues ex-president, demands compensation." *BBC Monitoring Ukraine & Baltics*: 15 July 2010. BBC. "Anatol Stati seeks US\$1.5bn damages from Vladimir Voronin." *Moldova Azi*: 16 July 2010.

<sup>488</sup> "Oil company withdraws staff from Moldova citing pressure as reason." *BBC Monitoring Ukraine & Baltics*: 26 August 2008.

Two months later, President Voronin sent a letter to President Nursultan Nazarbayev of Kazakhstan, a country in which Ascom had significant investments. In the letter, which was later leaked to the Moldovan opposition, Voronin urges Nazarbayev to pay “serious attention” to Stati and accuses Stati of using income earned in Kazakhstan to conduct “blood-tainted business” in Sudan, causing “severe damage” to Moldova’s reputation. Voronin also alleges that Stati “runs and finances propagandistic campaigns and in non-transparent ways funds political parties oppositional to the current government.”<sup>489</sup> After this letter, Ascom in Kazakhstan faced frequent inspections and criminal and civil cases. Kazakhstan went on to cancel licenses for two of Stati’s production subsidiaries, alleging “breach of subsoil use contracts,” which Ascom saw as the culmination of a “campaign of harassment.”<sup>490</sup> Ascom had invested over US\$990 million in Kazakhstan since 1999; by 2010, the firm’s assets were wholly confiscated.<sup>491</sup>

On 7 April 2009, protesters across Moldova called for a repeat of what they saw as flawed parliamentary elections of the day before.<sup>492</sup> Thousands of people participated in demonstrations and riots in an unprecedented show of support for political change in independent Moldova. Over the next several days, the presidential residence and the Parliament of Moldova were badly damaged. Gabriel Stati was arrested, accused of being the mastermind behind the demonstrations and having prepared a coup d’etat. In an 11 April press release, Anatol Stati wrote that he was “indignant” over his son’s arrest. Ascom

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<sup>489</sup> “World News: Moldova rulers turn up heat on business.” *Financial Times*: 29 May 2009.

<sup>490</sup> “Kazakhs take back licenses from trio,” *Upstream*: 6 August 2010. “Ascom urges international leaders to address Kazakhstan’s ‘Resource Nationalism’ as 40 Heads of State Gather in Astana for the OSCE Summit.” *PR Newswire Europe TWOTEN*: 23 November 2010.

<sup>491</sup> In 2010, Anatol Stati sued now ex-president Voronin, demanding he personally pay US\$1.55 billion compensation for the confiscation of Ascom’s assets in Kazakhstan “Moldovan billionaire sues ex-president, demands compensation,” *BBC Monitoring Ukraine & Baltics*: 15 July 2010.

<sup>492</sup> OSCE observers judged the elections as “generally free and fair.”

now moved all of its operations out of Moldova, and Stati pulled out of other personal investments; the loss of capital is estimated at US\$2.3 billion.<sup>493</sup> For a capital-scarce emerging economy, this was a huge loss. But, Stati was Moldovan, and the threat his activities posed to Voronin's political success outweighed the lost capital. In this case, there was no broader threat of other investors withdrawing their capital as a result. In capital-poor Moldova, Stati is an anomaly: few to no other multinational corporations of Moldovan origin exist that could have withdrawn their capital. Further, despite the billions of dollars involved, foreign executives interviewed at the height of the conflict in 2009 set such the Stati breaches aside as irrelevant to their own operations. This was a domestic conflict, which generated threats to domestic property rights but not to foreign. By implication, Voronin and the Moldovan government could take action against Stati without the fear that interference with domestic business would cause foreign capital to withdraw.

Anatol Stati's and Ascom's story of continually tense government relations is extreme but not uncommon among domestic Moldovan firms, especially those big enough or politically involved enough to offer rents to enterprising politicians. Due to the unique ties between Moldova and Russia, some domestic Moldovan firms have found ways to get their disputes heard in public IIAs.<sup>494</sup> But, executives at Russian multinationals as well as executives at other "true" foreign firms see such cases as evidence not of anti-foreign or anti-Russian actions but, rather, as the anomaly they are.<sup>495</sup> Foreign firms have not been

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<sup>493</sup> "Moldovan tycoon suspends operations in home country following riots," *BBC Monitoring Ukraine & Baltics*: 11 April 2009. "Stati accused of organizing Chisinau riots, coup attempt," *ITAR-TASS World Service*: 17 April 2009. Interview, foreign firm in business services, Moldova.

<sup>494</sup> Transnistrian and Moldovan residents sometimes hold Russian passports, so individuals with deep ties to domestic Moldovan politics have sometimes had access to international arbitration reserved for foreign firms.

<sup>495</sup> Interviews, various, Moldova.

free of struggles in Moldova, but they have not faced public breach of contract that resulted in the targeted firm's inability to continue operating in the country.

There is one exception. In 2002, the Moldovan government broke its shareholders' agreement with its German partner when it unlawfully replaced the head of the privatized national airline Air Moldova.<sup>496</sup> The Moldovan courts ruled that Air Moldova's founding documents were null and void, agreeing that the state has the right to act as it will because the company is "state property."<sup>497</sup> Moldova wholly renationalized the airline, forcing the German firm out. In 2008, the European Court of Human Rights awarded the German firm EUR6.7 million in compensation.<sup>498</sup> As a capital-poor country with a low FDI nationality mix, particularly in the early 2000s, Moldova suffered indirect losses from this breach. Consistent with the theory, Moldova lost access to German capital. Dresdner Bank pulled out millions from a planned aircraft purchase and cut off promised loans to Moldovan firms in natural resources and other industries.<sup>499</sup> German firms invested six times as much as Italian firms in 2003, but German and Italian firms' shares of FDI were equal in 2008. Consistent with the theory offered here, Moldova's renationalization of Air Moldova was a mistake, and the empirical record suggests Moldova incurred high costs because of it.

The best explanation for the renationalization of Air Moldova, and the government's willingness to incur the costs of breach over it, is corruption. The staff of the aviation

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<sup>496</sup> The German firm Unistar Ventures bought 49 percent of shares when Air Moldova was privatized in 2000. The agreement stipulated that 75 percent of the shareholders must agree in order to replace the head of the company.

<sup>497</sup> "Moldovan court rules in favour of state agency in airline dispute," *BBC Monitoring Former Soviet Union – Political*: 6 August 2002.

<sup>498</sup> *Unistar Ventures GmbH v. Moldova*, Application No. 19245/03, European Court of Human Rights.

<sup>499</sup> Interviews (3), Moldovan journalists, Moldova. "German bank threatens to stop investing in Moldova over airline row," *BBC Monitoring Former Soviet Union – Political*: 21 June 2002. "Moldovan government replaces airline director in defiance of German investors," *BBC Monitoring Former Soviet Union – Political*: 24 June 2002.

administration had been accused of corruption before, during, and after the Air Moldova sale.<sup>500</sup> Most notoriously, the man who had replaced the German-approved director of Air Moldova was arrested in 2005. He and several other top-level employees were charged with “large-scale embezzlement under a well-established criminal scheme.”<sup>501</sup> The mistake of renationalizing Air Moldova took place in the context of what was locally well-known corruption.<sup>502</sup> In this case, corruption led to a clear breach of contract, and the penalties such a breach predicts. But the corruption foreign firms face in Moldova has otherwise generally stopped short of this kind of outright expropriation.

### **Corruption, not broken contracts**

Foreign firms do not have an easy time of it in Moldova. Sometimes tax inspectors come too often; sometimes, in times of budgetary hardship, the government asks for taxes to be paid in advance. But foreign executives say, “well, we’re not in the West,” and “if we pay fines quickly, we get a 50 percent discount.”<sup>503</sup> In 2004, the President’s Office called the directors of Moldova’s 50 largest multinationals to an appointment, at which each director was presented with the amount his or her firm was to donate to a campaign to renovate two monasteries.<sup>504</sup> In 2008, one-half of one of the monasteries had been renovated. Such instances point to problems with the broader “business climate” in Moldova that might give foreign firms pause before opening operations in the country. Indeed, these particular

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<sup>500</sup> For example, in 1999 the director was accused of taking a cut on sales to a Russian firm, illegitimately selling the state-owned travel agency, and founding a competing airline to seize profitable routes from Air Moldova. “Moldovan civil aviation chief denies corruption charges,” *BBC Monitoring Former Soviet Union – Political*: 11 December 1999. An audit of the Administration in 2002 revealed that much touted airliners from Brazil had been purchased at inflated prices. “Moldovan civil aviation chief sacked over airline row,” *BBC Monitoring Former Soviet Union – Political*: 14 August 2002.

<sup>501</sup> “Former Moldovan state airline officials arrested,” *BBC Monitoring Ukraine & Baltics*: 21 March 2005.

<sup>502</sup> Interviews (3), Moldovan journalists, Moldova.

<sup>503</sup> Interviews (2), foreign firms in business and financial services, Moldova.

<sup>504</sup> The ‘requests’ for donations stopped prior to the 2005 presidential election.

instances of corruption targeted foreign investors over domestic investors.<sup>505</sup> However, these issues are not specific to one firm and its co-national group. Rather, these are the kinds of issues around which foreign firms in Moldova, Ukraine, and elsewhere coalesce. In 2009, for example, interviewees suggested that there was growing interest for foreign firms of different national groups to get together and pen white papers on corruption and the like. As we saw in the previous chapter on Ukraine and its threats of reprivatizing property across the whole economy, when all foreign firms are affected by a government action, all foreign firms are more likely to respond. However, a bigger list of corrupt activities could be made of corruption faced by Moldovan small and medium enterprises – not to mention Anatol Stati and other large domestic firms.

Foreign firms in Moldova, while not without problematic relations with the Moldovan government, have been largely free of experiencing government breach of contract. As predicted, this has occurred although foreign firms in Moldova do not come together across national lines. Even in a country with relatively few foreign firms and relatively few nationalities represented, where cross-national collective action problems would be theoretically easier to overcome, co-national foreign firms continue to respond to co-national threats of breach. But, with few sources of capital on which to depend, the Moldovan government looks to domestic and not to foreign firms to score political points by breaking contracts.

## **Breach in Romania**

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<sup>505</sup> “Corruption in Moldova is dysfunctional – can’t bribe the right people, and the right people can’t do what you want them to do.” Interview, foreign firm in financial services, Moldova.

Since 1990, the FDI nationality mix in Romania grew and plateaued at a high level, considerably higher than Moldova's (see Figure 3). In the late 2000s, Romania consistently hosts one of the most mixed groups of OECD investors among emerging economies, even after the general withdrawal of capital during the world financial crisis.<sup>506</sup> In this diverse environment, the expectation is that co-national investor lobby groups should be slower to form, as their impact on the likelihood of government breach of contract is weak. With so many alternate sources of foreign capital on which to rely, the Romanian government has space to break contracts publicly and with prominent foreign firms. These predictions are put to a difficult test in Romania, as during the 1990s and 2000s the country took pains to institute a market economy and reform political life in order to join the European Union (EU), which it did in 2007. In fact, the EU has tacitly supported breach of contract in Romania as well as in other accession countries. Far from explaining variation in breach behavior between Moldova and Romania, Romania's deeper commitments to international institutions have sometimes reinforced the government's anti-foreign investor behavior.

### **Weak co-national understanding**

In contrast to strong nationality-tied investor associations in Moldova, nationality-tied associations in Romania tend to focus on networking and have few to no lobbying activities. The American Chamber of Commerce in Romania, for example, has a policy of not advocating for particular firms. When an executive from one of their newest members brought up a particular conflict with the government, the AmCham leadership "shut her

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<sup>506</sup> See chapter 4 for international comparisons.

up.”<sup>507</sup> The AmCham is worried that lobbying on a particular American firm’s behalf would compromise its access to the authorities altogether.<sup>508</sup> This logic is consistent with the expectation that, with a high FDI nationality mix, the Romanian government is not especially beholden to American firms. Rather, government officials can more credibly threaten to ostracize national groups that would press on particular disputes. One foreign executive, commenting on the AmCham, assesses that the organization has a “brand,” but it has basically become a “Romanian association of Romanians wanting to be Americans.”<sup>509</sup> Large American multinationals are members, but so too are enterprises originating in Romania that have interests in the US. American members have not seen it worthwhile to change the organization’s focus. The AmCham provides information to the American Embassy and uses it as “our loudspeaker,” but executives interviewed at American firms provided few examples of active support from embassy officials. Other foreign investor associations are similarly arranged around nationality and weak when it comes to protesting government breach of contract with their members. The British Chamber of Commerce is seen as mainly a social club, and the British are known to “hang out” alone. Executives of other nationalities also agree that Austrians, French, and Germans all keep to themselves.<sup>510</sup> None of these other national groups have active investor associations, nor is there much evidence of their embassies speaking out on investors’ behalf.

Do multilateral groups fill the void left by weak national coalitions? The Canadian Business Association (CBA) is a young organization hoping to provide members with more

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<sup>507</sup> Interview, American AmCham member, Romania. Another American executive said, “We don’t need AmCham lobbying.” Interview, foreign firm in business services, Romania.

<sup>508</sup> Interview, American AmCham member, Romania.

<sup>509</sup> Interview, foreign law firm, Romania.

<sup>510</sup> Ibid.



services than only networking. Despite its name, it is deliberately opening up to not just Canadians but a nationally diverse membership. This is reminiscent of “the Chamber” in Ukraine, the American Chamber of Commerce’s reformulation as a widely representative group. While such groups can be useful in pressing host governments on issues of general interest to foreign firms, like tax law or corruption, they do not advocate on behalf of particular firms facing breach of contract. In the case of one very public, acrimonious government breach of contract with a Canadian firm, the CBA’s stance is that it “understands both positions”; it has taken no overt action on the firm’s behalf, although the firm is a CBA member.<sup>511</sup> A Romanian Foreign Investor Council (FIC), usually run by Americans and to which large firms of various nationalities subscribe, has been active since the 1990s. The local head of a large foreign bank calls the FIC “quite influential,” but that influence is again around broad-based policy reform and not particular breaches of contract.<sup>512</sup> Government breach of contract with a particular firm does not draw the interest of Romanian associations representing all foreign firms, of all national origins. Foreign executives from European Union countries lament that EU groups suffer from this same reluctance to get involved in particulars; these groups also focus on broad issues and shy away from ultimately bilateral conflicts.

Industry associations are not a substitute for co-national lobbying around contract breach, either. For example, the Romanian pharmaceutical industry association includes foreign firms, but foreign members see it as ineffective: “just complaining, not engaging.”<sup>513</sup> Foreign-owned banks have been very isolated in Romania and have not been participants

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<sup>511</sup> Interviews (2), Canadian firms, Romania.

<sup>512</sup> Interview, French firm, Romania.

<sup>513</sup> Interview, foreign law firm, Romania.

in Romanian banking associations. The local head of a prominent Western bank regretted the absence of foreign bank associations and attributed this to diversity among foreign firms' home country banking cultures.<sup>514</sup> There is a foreign investor "club" for firms interested in infrastructure, but it is "only to find clients" and not a source of lobbying power.<sup>515</sup> Foreign firms in oil and gas and natural resources described occasional collaborations in the 1990s, but these have fallen apart. In particular, co-industrial support has been absent in the several government breaches of contract with resource investors in the 2000s (discussed below). In the words of a local manager of a foreign firm, associating with professional groups can be "a form of survival, but they are not a proper lobby."<sup>516</sup>

Many foreign executives share the sentiment that "the government is only interested until firms invest here. After that, they don't care."<sup>517</sup> Bureaucrats at Romania's investment promotion agency, Romania Trade and Invest (RTI), dispute this. They pride themselves on the "after-market services" they agency has developed to ensure the success of new foreign investments once they have been made. However, RTI and foreign executives agree RTI does not support firms should they find themselves in conflict with the government.<sup>518</sup> Romania has a culture in which local directors of foreign firms can sometimes meet with the Prime Minister, but respondents that have been to such meetings agree that they have not been effective in resolving particular disputes. With a diverse FDI nationality mix, Romanian officials can better afford to take actions that deter investment.

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<sup>514</sup> Interview, French firm, Romania.

<sup>515</sup> Interview, American firm in business services, Romania.

<sup>516</sup> Interview, British firm, Romania.

<sup>517</sup> Interviews, various firms and foreign investor associations, Romania. There was popular celebration when Nokia moved some operations from Germany to Transylvania; on the flip side, there was a public scandal when Mercedes decided to build a plant in Hungary instead of Romania. Interviews (2), foreign firm in business services and local news media, Romania.

<sup>518</sup> Interview, Romanian government official, Romania.

In fact, Romanian officials are antagonistic to some nationalities of investors even before investment takes place. For example, foreign executives of various nationalities agree that Russian investors are frowned upon. One foreign executive noted that the government has an “obsession with not letting Russians in. If there’s a choice, they choose Western.”<sup>519</sup> Commenting on discussions over a new nuclear power plant, another executive (in an unrelated industry) observed that Russians wanted to build it but that the government “won’t ever give it to them,” as it would naturally prefer the French bidders.<sup>520</sup> In contrast to Moldova’s continued reliance on Russian direct investment, Romania’s diversity of OECD investors allows it to selectively deter Russian investment before contracts are formed.

### **Breach with international approval**

The Romanian government has broken contracts, and in a high profile way, even after joining the EU in 2007. With a high FDI nationality mix, the expectation is that the Romanian government has the autonomy to take such actions and will face relatively few penalties, in terms of the loss of capital or diplomatic standing, as a result of it. These expectations hold true in the prominent breach of contract with a Canadian firm that has inflamed public debate since the mid 2000s and still brings protesters to the street in 2012.

The Romanian state extracted gold from the Rosia Montana region in the northwest of the country for fifty years, until 2006. This is considered perhaps the richest mining region in Europe, with gold mining traceable back to ancient Roman installations. In 1998, the Canadian (and later Canadian-American) firm Rosia Montana Gold Corporation (RMGC)

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<sup>519</sup> Interview, French firm, Romania. This executive went on to say that he thinks Russians resort to making “undercover” investments in various industries in Romania, where their identity is masked via intermediaries of other nationalities.

<sup>520</sup> Interview, foreign firm in business services, Romania.

received permission to exploit the mines.<sup>521</sup> After making some US\$380 million in initial investments, RMGC applied in 2006 for the state to carry out the inspections necessary for environmental permits to be issued. In 2007, Romanian investigators unexpectedly stopped their inspections after the conservative-leaning coalition government broke up. Rather than find that environmental damage would be too high to allow the mine to operate, or find that the mine can operate, or declare what RMGC needed to do to get environmental approval, the process simply stopped. Its fate is still in limbo as of 2012. The Romanian government's decision to unilaterally and without reason stop and not restart the evaluation constitutes a broken commitment to RMGC. At stake is a US\$4 billion investment over 16 years, which would employ up to 3000 workers in a region with 80 percent unemployment. In January 2012, Some Rosia Montana locals with signs like, "We Live on Gold, We Die of Hunger."<sup>522</sup>

However, the Romanian government has incentives to maintain its indecisiveness. Romanian and international actors have applauded the Romanian government for suspending operations at Rosia Montana. Local and international environmental non-governmental organizations (NGOs) worry about the protection of groundwater in an important Danube watershed area. RMGC's plans are to use cyanide at the mine, a common agent in the process of extracting gold from ore, and to maintain cyanide tailings ponds in the process of wastewater management. Central Europe is particularly sensitive to cyanide mining since a tailings pond collapsed in Baia Mare, Romania in 2000, and contaminated water ultimately spilled into the Danube in Hungary. In response to this disaster, the 2006 EU Mining Waste Directive required mines to reduce cyanide parts per million (ppm) from

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<sup>521</sup> RMGC is a subsidiary of Gabriel Resources.

<sup>522</sup> "Canadian-Romanian goldmine draws protests," *Agence France-Presse*: 28 January 2012.

a maximum of 50 ppm down to 10 ppm by 2018. According to RMGC, the Rosia Montana mine would have a concentration of 5 to 7 ppm. However, neighboring Hungary has banned the use of cyanide mining altogether. NGOs are also worried about the impact a new mine would have on the Roman archeological findings in the area. While these NGOs support the suspension of operations at Rosia Montana, its limbo status continues to bring protesters to the streets. In January 2012, for example, hundreds marched in Bucharest with signs like, “Yes to Culture, No to Cyanide.”<sup>523</sup>

For its part, RMGC has found few allies in trying to reinstate its contract. RMGC has itself fought hard to reinstate its property rights: it has held many public debates in Romania as well as Hungary; its leaders have met several times over the years with Romanian presidents and prime ministers; it has public information campaigns on television and in print; it engages in corporate social responsibility activities; and so on.<sup>524</sup> But neither co-nationals nor co-industrials stood with it in its conflict with the government. The Canadian embassy has helped in RMGC’s educational initiatives, but the embassy has paid no special attention to RMGC in relation to Canadian investment in Romania.<sup>525</sup> RMGC acquired American investors in the late 2000s, but the American embassy has not been helpful in its fight.<sup>526</sup> Executives at Canadian, American, and other nationalities of firms recognize that Rosia Montana is a “hot potato.”<sup>527</sup> No foreign firms have openly supported RMGC and, indeed, few executives at top multinationals are personally sympathetic behind closed doors. Some agree that, “in the long term, RMGC will hurt the

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<sup>523</sup> Ibid.

<sup>524</sup> Ibid

<sup>525</sup> Interview, Canadian firm, Romania.

<sup>526</sup> Ibid.

<sup>527</sup> Interviews, various, Romania. Quotation from American firm.

environment.” Others accuse the firm of “dirty tricks,” citing evidence that RMGC “turns off locals’ power and services” in order to make them move off their land around the mine site.<sup>528</sup> In a diverse investor environment where co-national leverage is weakened to begin with, Canadian actors have little incentive to support a firm about which some individuals have their own compunctions. Rather than jointly fight a losing battle, Canadian firms choose to manage their own risk of breach of contract by downplaying national ties and differentiating themselves from RMGC, a strategy implied by the theory laid out here.<sup>529</sup>

Long-time foreign executives in Romania described a “common understanding” that once existed between foreign mining firms and oil and gas firms, but this was gone by 2009.<sup>530</sup> For example, another Canadian firm, Sterling Resources, faced a broken contract from 2009 to 2011, during which time a law prevented them from developing Black Sea oil blocks that they had purchased from the government. Sterling Resources was vocally frustrated, claiming there were “deliberate and discriminatory actions” against their operations including “media attacks and various actions to block the progress of the company’s activities.”<sup>531</sup> RMGC, too, complained of government misinformation about its operations. Yet Sterling Resources did not publicly stand together with its co-national, and its fellow resource firm RMGC. Sterling Resources did, however, take advantage of other nationality-tied resources to repair its broken contract, using the threat of international

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<sup>528</sup> Interviews (2), foreign firm in business services and international NGO, Romania.

<sup>529</sup> Interview, Canadian firm, Romania.

<sup>530</sup> According to a foreign executive in the mining industry, the domestic mining industry association in Romania “has nothing to do with politicians and officials” and RMGC is not associated with it. Interview, Romania.

<sup>531</sup> “Sterling buoyed by permit change,” *Platts Energy in East Europe*: 21 October 2011. The local press reported suspicions that some parts of the coalition government were trying to force Sterling Resources out in favor of the state-owned company Romgaz. Consistent with these suspicions, Prime Minister Boc accused the previous Prime Minister, who had made the deal, of “undermining the national economy by sealing the agreement with Sterling,” saying that he broke the law and planned “a business to favor certain interest groups.” The former PM accused Boc of slander; Boc won the subsequent court case. “PM Boc wins lawsuit with former PM Tariceanu over Sterling business,” *Rompres*: 19 October 2011.

litigation under the Canada-Romania BIT to persuade the government to reinstate its ability to operate, though its fight took two years.

Perhaps multilateral actors have come to support RMGC? One may expect economic- and development-oriented multilateral actors to be on the side of international business, especially in a case where breach is not about deeming an investment unfit but about the refusal to make that decision. Certainly, institutions like the European Union must balance the interests of capital-exporting countries and emerging economies that now both number among their membership. Yet surely pushing an EU member to follow through on its self-defined bureaucratic procedures is consistent with a balanced approach? RMGC has thought as much, as it has repeatedly appealed to various bodies in the European Union. But the EU has largely withheld judgment; the most decisive action taken has been against RMGC's interests. In a 2010 non-binding resolution, the European called "on the Commission and the Member States not to support, either directly or indirectly, any mining projects in the EU that involve cyanide technology."<sup>532</sup> The UN Development Program has no official position on the matter, despite having been pressed for one by advocates for both sides of the issue. Development banks remain uninvolved.<sup>533</sup> And international environmental NGOs have come out strongly against RMGC, with foreigners funding and marching alongside Romanian protesters. Thus, RMGC has found itself isolated, without either a co-national or a multilateral community to call on in its fight against a long-time broken contract in an EU member state. Consistent with the theory, FDI nationality diversity decreases a targeted foreign firm's sources of power and leverage over a

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<sup>532</sup> "European Parliament resolution of 5 May 2010 on a general ban on the use of cyanide mining technologies in the European Union."

<sup>533</sup> Interview, international organization, Romania.

recalcitrant host government. A host government can find domestic approval and international approval or indifference, despite acting against a foreign firm's interests.

The American construction company Bechtel Group faced trouble from the beginning over its contract to build a Transylvanian highway. The Romanian government forced renegotiation of the contract several times after its original signing in 2003; in 2011, Romania officially broke the contract and Bechtel agreed to give up its right to compensation. American actors spoke publicly only a handful of times about Bechtel, and, in the end, the US Ambassador to Romania acted as mediator facilitating the Romanian breach.<sup>534</sup> German, Austrian, and other nationalities of investors were clamoring to build Romania's much-needed roads. Moreover, the European Union was satisfied with the breach of a contract it refused to support from the beginning.<sup>535</sup> In an environment with a high FDI nationality mix, the Romanian government broke, without direct costs and without EU penalties, a written contract that one official had lamented was "virtually unbreakable."<sup>536</sup>

In 2003, the Social Democratic Nastase government awarded Bechtel a EUR2.2 billion contract to build a 500-kilometer highway without a public tender process, despite Romanian legislation requiring it. A "furious" European Union had just funded a road running almost parallel for EUR500 million. As a result, the EU did not allow Romania to use any of its EUR4.6 billion in EU infrastructure funds to pay for the project, setting the

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<sup>534</sup> "President Basescu: Bechtel contract, unfortunate, both parties acted incorrectly," *Rompres*: 19 September 2011.

<sup>535</sup> "US Ambassador says expropriations, poor financing hinder construction of Romania's Transylvania highway," *Mediafax News Brief Service*: 24 October 2010. "Special Report: Romania's Roads to Nowhere," *Reuters News*: 26 May 2011.

<sup>536</sup> "Special Report: Romania's Roads to Nowhere," *Reuters News*: 26 May 2011.



stage for years of struggle as Romania paid for the project out of its own budget.<sup>537</sup> The pricey Bechtel contract figured prominently in Romania's 2004 elections, which the Nastase government lost. The new Basescu government forced renegotiations in 2005; Bechtel agreed to a price decrease of EUR126 million.

The Nastase-signed contract was originally confidential, but over the years the Basescu government chose to make parts public. Originally, Bechtel was to get an interest-free loan of EUR250 million on top of monthly payments for its work. Bechtel was in charge of controlling costs and deciding the route, and there were no provisions for an audit until 2012. Most importantly, it was virtually impossible under Romanian law to pursue compensation if Bechtel failed to meet its obligations. Bechtel, on the other hand, had access to international arbitration and a provision that banned the state from continuing construction works on the highway for two years should Romania terminate the contract.<sup>538</sup> These provisions led to considerable consternation among Romanian officials who felt they had been cheated in a raw deal made by the Nastase government.

Like many large-scale construction projects, the Transylvania highway quickly overran costs. In 2008, the Romanian press reported that total costs would more than triple to EUR7 to 8 billion.<sup>539</sup> Scandals arose when Bechtel hired hundreds fewer Romanian workers than expected and paid Turkish workers higher wages than locals.<sup>540</sup> Romania threatened to cancel the contract, forcing another renegotiation in which Bechtel agreed to forego its interest-free loan as well as receive only 50 percent of its payment in Euros and

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<sup>537</sup> John W. Miller. "Focus: EU Eyes Public Contracts as Romania's Roads Boom." *Dow Jones Capital Markets Report*: 26 June 2006. "Special Report: Romania's Roads to Nowhere," *Reuters News*: 26 May 2011.

<sup>538</sup> "Potential termination of Bechtel contract entails huge costs for Romania – Ex Transport Minister," *Mediafax News Brief Service*: 27 March 2009.

<sup>539</sup> "US Bechtel company, constructor of Romania's..." *Rompres*: 16 July 2008.

<sup>540</sup> "US Bechtel company, the developer of the..." *Rompres*: 28 March 2007. "The American company Bechtel has so far employed..." *Rompres*: 9 August 2007.

the rest in Romanian Leu.<sup>541</sup> Still, Romanian ministers made new threats to terminate the contract.<sup>542</sup> Romania stopped prioritizing payments, and its debts to Bechtel fluctuated between EUR100 and EUR215 million; the Transportation Minister suggested that “Bechtel should take out a loan” to fund its work.<sup>543</sup> By 2011, the highway was only 10 percent complete, and the estimated price per kilometer had gone from EUR5.4 million to EUR16 million.<sup>544</sup>

The contract made front-page news for years, and foreign firms of all nationalities steered clear. The already weak American lobbying capacity in the country did little, publicly or privately, on Bechtel’s behalf.<sup>545</sup> Early in the conflict, the Prime Minister declared that Romania would not agree to special treatment for Bechtel, “even if they are an American company.”<sup>546</sup> At first, the US Ambassador kept a positive public attitude, focusing cheerfully on prospects for other American firms in the country and remaining “confident that the Romanian government and Bechtel will find a way.”<sup>547</sup> In 2011, the new US Ambassador told top Romanian officials that the broken contract “is also about a big Turkish company, it is not only about Romania and an American company.”<sup>548</sup> By emphasizing the Turkish subcontractor Enka’s participation in the project, the US Ambassador tried to unite foreign firms’ experiences across national lines. The theory

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<sup>541</sup> “Romania, US Bechtel agree to give up highway advance payment in ‘09,” *Mediafax News Brief Service*: 22 January 2009.

<sup>542</sup> “Potential termination of Bechtel contract entails huge costs for Romania – Ex Transport Minister,” *Mediafax News Brief Service*: 27 March 2009.

<sup>543</sup> “Special Report: Romania’s Roads to Nowhere,” *Reuters News*: 26 May 2011.

<sup>544</sup> “Romania’s overdue debts to Bechtel run to 111 mln euros, 1 km costs 16 mln euros,” *Rompres*: 30 May 2011.

<sup>545</sup> Interviews (3), American actors, Romania.

<sup>546</sup> “Bechtel holds Romania’s Transylvania highway back, Not Funding – Romanian PM,” *Mediafax News Service*: 21 October 2008.

<sup>547</sup> “US Ambassador says expropriations, poor financing hinder construction of Romania’s Transylvania highway,” *Mediafax News Brief Service*: 24 October 2010.

<sup>548</sup> “US Ambassador Gitenstein says confident Bechtel contract arrears issue to be resolved,” *Rompres*: 2 June 2011.

described here suggests that actors should try to make such cross-national connections but that they will be largely unsuccessful. Indeed, Enka never took a public stand together with Bechtel, Enka's opinions on the affair did not make it into the Romanian news, and the Turkish Ambassador did not take a public position on the Bechtel dispute. The public record shows virtually no cross-national action, and the US Embassy made no other public attempts to spur it.

In the end, Romania cancelled the contract. Over the several renegotiations, Bechtel had given up EUR126 million, a EUR250 million interest-free loan, and, according to insiders, other still confidential "hidden costs" to the Romanian government.<sup>549</sup> In late 2011, Bechtel agreed to forego its contract altogether for the six unfinished sections of highway. Moreover, Bechtel gave up its recourse to international arbitration and Romania paid no penalties to Bechtel for the breach.<sup>550</sup> Far from condemning this outcome, the US Ambassador "praised the breakthrough." President Basescu said the outcome was possible "thanks to the support of the US Embassy."<sup>551</sup> Bechtel – and what American support system they had – cut their losses. Again, investors of other nationalities (including Turkish) remained aloof, as did other American actors in Romania. The European Union praised Romania's new, public tenders for highway construction. In this situation, much worked against Bechtel: breach aligned with the EU's desires; the original contract was the symbol of a political rival; Romania had more investors to rely on than just the American contingent; and American actors recognized their weakness and were absent from

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<sup>549</sup> "Special Report: Romania's Roads to Nowhere," *Reuters News*: 26 May 2011.

<sup>550</sup> Romania agreed only to pay its debt of EUR90 million to Bechtel before auctioning off tenders for the other six sections. "Romania re-negotiates contract with US company Bechtel for highway," *Associated Press Newswires*: 4 August 2011.

<sup>551</sup> "Romania to make outstanding payments worth 90 mln euros to Bechtel in two tranches," *Rompres*: 4 August 2011.

Bechtel's fight. The Basescu Romanian government retained the ability to renegotiate over the years and finally walk away. In the words of one Romanian Senator, Romania's breach aligned with "the dignity of a European country" – a fascinating statement when one remembers the conventional wisdom that European, capital-exporting countries are unquestionably on the side of foreign firms.<sup>552</sup>

In fact, post-communist member states' contracts with foreign firms have conflicted with European Union mandates on several occasions. For example, several cases brought against Hungary and Romania deal with subsidies offered to foreign firms as part of investment promotion efforts. Hungary and Romania later canceled those subsidies after investors had entered, as the governments believed they were probably incompatible with EU rules on state aid.<sup>553</sup> From the foreign firms' point of view, the implementation of EU law via government breach of contract was unfair.<sup>554</sup> From the governments' point of view, breach earned them approval from the EU. Empirically, even the EU sometimes supports breach. When foreign firms are diverse and the costs of breach in terms of lost capital are low, government breach of contract and compliance with the EU appears the sensible option.

## **Breach of privatization contracts**

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<sup>552</sup> "Agreement with Bechtel must be urgently annulled (Conservative Senator)," *Rompres*: 13 July 2011.

<sup>553</sup> Karl-Heinz Boeckstiegel, "The Relationship of BITs and other international law obligations." Talk at *50 Years of Bilateral Investment Treaties Conference 2009*. 2 December 2009. See also: *The EU Approach to International Investment Policy after the Lisbon Treaty*: October 2010. Cases are *Micula v Romania* (ICSID ARB/05/20), *Electrabel S.A. v Hungary* (ICSID ARB/07/19), *AES Summit Generation Ltd and AES-Tisza Eromu Kft v Hungary* (ICSID ARB/07/22); *EDF International S.A. v Hungary* (UNCITRAL ad-hoc). "Micula brothers obtain first victory by a private investor against the Romanian state," *Rompres*: 3 October 2008.

<sup>554</sup> Ulrich Woelker, "The EU as a Player in the BIT Arena." Talk at *50 Years of Bilateral Investment Treaties Conference 2009*. 2 December 2009.

As in Ukraine and elsewhere among emerging economies, privatization contracts in Romania have been particularly vulnerable to breach. Privatization contracts in Central and Eastern Europe often come with provisions about preserving the “scope of investment” to prevent asset stripping, to limit layoffs and restructuring, and to ensure the new owners’ commitments to reinvestment. Romanian privatizations took place throughout the 1990s and 2000s, but with no long term monitoring of agreements, some owners did strip assets and sell their acquired land despite contractual terms. This gave rise to “gray” situations in which domestic and foreign investors’ claimed that without flexibility in these scope clauses, their investments would die, while the Romanian government argued that it had legal justification to renationalize and reprivatize such property.

When domestic investors were on the other end, the Romanian government was free from the threat of foreign capital flight if it chose breach. By 2009, Romania had privatized 11,261 firms to domestic investors, and 1,144 privatizations, or 10 percent, had been revoked and renationalized. Conventional wisdom would posit that, while domestic firms might be renationalized, foreign firms would have the leverage necessary to protect their contracts, even when either side interprets contractual clauses differently. Yet of 352 privatizations made to foreign investors, 18 had been revoked and renationalized by 2009.<sup>555</sup> While this number may seem small, foreign investors tend to buy into some of the largest assets being privatized, so renationalizations of foreign-owned assets have a substantively large and visible impact. Unprompted, executives at foreign firms of different nationalities brought up the revocation of privatization contracts in Romania as a “big

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<sup>555</sup> Data from Interview, foreign firm in business services, Romania.

issue.”<sup>556</sup> Renationalization in Romania has made it to public international investment arbitration, as Turkish investors brought a lawsuit against Romania’s privatization agency in 2011. That Romania has renationalized privatizations made to foreign investors again shows that the loss of capital around any particular broken contract is not the monolithic deterrent that conventional wisdom would have us believe.

### **Breach and domestic politics**

In the times of a high FDI nationality mix, the Romanian government has on several occasions gone a long way down the path of “creeping expropriation” with foreign firms. In these prominent cases, the government’s ultimate pull back from nationalization has been due to two interrelated factors: contract breach would potentially spread to more nationalities of investors, and domestic political interests changed. When domestic politics is on the side of breach, and the government has many sources of capital, it follows that Romanian governments take the opportunity to breach. But, when breach could cross national lines and domestic political opinion changed, the Romanian government called a stop to it. Both the beginning and end of breach under these circumstances fit with the theory’s predictions: host governments have autonomy to breach or maintain sanctity, based on their own incentives, but the costs of continuing to breach increase when more than one national group feels threatened.<sup>557</sup>

In the vein of the Bechtel scandal discussed above, the Romanian government was close to nationalizing the Austrian oil and gas firm OMV. But, after government actions threatened more than just Austrian interests and political alliances were reconfigured, the

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<sup>556</sup> Interviews (3), foreign firms in business services and foreign law firm, Romania.

<sup>557</sup> For examples from Ukraine, see chapter 5.

government only forced a costly renegotiation of OMV's contract that, nevertheless, linked to a substantial decrease in its share price. Romania's Natase government negotiated OMV's contract in 2004, in which OMV paid US\$1.8 billion for a 51 percent stake in the Romanian state oil company Petrom. That sales price was based on long-term world oil price estimates of US\$20 to 30 per barrel. As the oil price – and OMV's profits – went up, the Romanian government and people felt cheated, with one politician calling the privatization an “amazing theft.”<sup>558</sup> The privatization contract was strict: the Romanian state could not increase royalties, add taxes on production, or change the contract's foundational assumption of low oil prices. OMV was also free to eliminate 50 percent of Petrom's 50,000 jobs by 2009, and the state took over liability for environmental damage caused before OMV took ownership.<sup>559</sup> When the terms of OMV's investment were made public in 2006, unrest over the deal skyrocketed. To throw salt in the wound, EU accession required domestic Romanian energy prices to converge with EU levels, and OMV argued that Petrom's viability depended on higher prices.

As with the controversy over the Bechtel contract, the OMV contract put Natase's now-opposition Social Democratic Party (PSD) on the defensive and Basescu's government on the offensive.<sup>560</sup> In 2006, two Romanian officials were arrested on suspicion of treason for passing information on Petrom to OMV during the privatization negotiations. Employees of Credit Suisse First Boston, which had brokered the deal, were arrested as

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<sup>558</sup> “Official: Romania's Petrom Sale, Relinquishing Oil Reserves - “Amazing Theft,” *Mediafax News Brief Service*, 18 August 2006. “Romanian president seen under public pressure to review energy privatization,” *BBC Monitoring European*: 17 November 2006.

<sup>559</sup> “Romanian scandals to delay further sales,” *Platts Energy in East Europe*: 8 December 2006.

<sup>560</sup> “OMV Views Pres' Petrom Sale Criticism As Politics – Source,” *Dow Jones International News*: 19 September 2005. “Romanian opposition party defends Petrom privatization contract,” *BBC Monitoring European*: 20 September 2005.

part of an “organized crime ring.”<sup>561</sup> President Basescu used popular animosity toward Russia to good effect, claiming (erroneously) that Russia’s Gazprom “massively” bought up OMV shares and that it “may be the real decision maker” behind the Austrian firm.<sup>562</sup> Against PSD politicians’ protests, Basescu called for the review of the contract, and the relevant ministry drew up an “Emergency Ordinance” to increase taxes and royalties on oil production.<sup>563</sup> In 2007, the Romanian Senate approved a bill cancelling the privatization and sent it to the lower house, the Chamber of Deputies.<sup>564</sup>

OMV’s local representatives appealed to the original privatization contract. There was no cross-national domestic support from other foreign firms, and Austrian firms also kept a low profile. The Austrian Ambassador to Romania supported OMV, publicly pointing out that 4,500 Austrian companies had invested EUR12 billion in Romania, in banking, real estate, insurance, construction materials, IT, and oil and gas.<sup>565</sup> This strategy of calling on Austrian firms’ broad contributions to Romania fits with the implications of the theory. But, with non-Austrian investors on which to call, it was not sufficient to deter a wide contingent of Romanian politicians.

The bill cancelling the privatization to OMV died in the Chamber of Deputies, but its death was not obviously caused by Austrian action. Instead, it surfaced that the government’s “Emergency Ordinance” to increase taxes and royalties would threaten not only the government’s contract to OMV but also its contract with British, American, and

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<sup>561</sup> “Romanian scandals to delay further sales,” *Platts Energy in East Europe*: 8 December 2006.

<sup>562</sup> *Ibid.*

<sup>563</sup> “Romania’s ANRM To Propose Higher Royalties On Oil Prod,” *Mediafax News Brief Service*: 21 September 2007. “Romania Oil Tax, Royalty Hikes Will Not Change Contracts - Econ Min,” *Mediafax News Brief Service*: 2 October 2007.

<sup>564</sup> “Romanian Senate initiates cancellation of oil firm Petrom’s privatization by Austria’s OMV,” *Hungary Business Newswire*: 5 December 2007.

<sup>565</sup> “OMV Expects Romania To Honor Petrom-Contract, Not Raise Fees,” *Dow Jones International News*: 25 October 2007. “Austria becoming big investor in Romania,” *Austria Today*: 31 October 2007.



Canadian firms, as well as Romanian firms.<sup>566</sup>As we saw in chapter 5, broad, cross-national threats to break contracts can inspire protests by all those national groups targeted. For a government already embroiled in a dispute with a Canadian firm RMGC and an American firm Bechtel, activating more foreign investors (not to mention domestic investors) would strengthen investor opposition and weaken the government's ability to follow through with breach. From OMV's point of view, it helped that the former Economic Minister responsible for Petrom's privatization was a member of the Chamber of Deputies when the bill cancelling the privatization came through. This individual, and the larger PSD of which he was a member, were particularly sensitive to the broader implications of breaking OMV's contract and wanted it to remain intact.

In the end, OMV agreed to contribute to a social fund to subsidize individual consumer prices. This was despite the fact that OMV's stock lost 4.7 percent in a matter of days when the OMV CEO first discussed such a "solidarity fund" with President Basescu a year earlier in 2006.<sup>567</sup> What might have been a renationalization became effectively a forced renegotiation. The possibility of escalating the conflict by breaching contracts with investors of other nationalities, as well as political partisanship, limited the extent of breach OMV faced. In an emerging economy with a high FDI nationality mix, targeting not one but many national groups with a government action is a high cost to bear.

## Conclusion

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<sup>566</sup> "MP Says Deputies To Reject Bill On Annuling Petrom Sale," *Mediafax News Brief Service*: 7 December 2007. "Producers oppose royalty hike," *Platts Energy in East Europe*: 9 November 2007.

<sup>567</sup> "Romania's President Met With CEO Of Austrian Oil Co OMV," *Mediafax News Brief Service*: 20 November 2006. "Romanian Govt Drops Examination Of Energy Privatizations," *Dow Jones Commodities Service*: 16 January 2007.

Romania is not the place one would expect contract breach, and Moldova is not the place for sanctity. As a European Union member state, and a wealthier country, with an economy more integrated into international financial markets, Romania has reasons to welcome and respect the contracts of foreign firms. But, the EU sometimes approves of breach, and wealth and exposure to financial markets has not offset the contrary effect of the presence of a greater diversity of foreign firms. With more investor nationalities in the country, Romania has alternative sources of capital on which to rely when it breaches with any one group. Accordingly, any one group of co-national investors has fewer incentives to organize lobbying campaigns, and diplomats have fewer incentives to put bilateral relations on the line over battles unlikely to be won. As a result, Romania has broken contracts even as it has moved closer to the transition “success stories” of Central Europe.

Moldova, on the other hand, is poor. With legacy ties still remaining to its Soviet past, a relatively weak democracy, and endemic corruption, one might expect breach of contract to be widespread. In fact, domestic firms find their contracts broken more often and more thoroughly than foreign firms. While a few foreign firms have gotten embroiled in disputes with the Moldovan government, and foreign firms in general struggle with navigating corruption in the country, breach of contract that precludes the operation of a foreign firm has been rare to non-existent. With a much more intimate set of foreign firms in the country, Moldova has fewer outside options for capital should it choose to breach. Nevertheless, protest against breach takes place along national lines even in such a small country. Foreign firms and diplomats exert pressure on behalf of their co-nationals but retain distance from other firms’ disputes. Breach is contained thanks to co-national, and not cross-national, threats of exit and collective action.

## Figures and Tables

**Table 1. Summary of major contract disputes in Moldova and Romania, as discussed in the text.**

FDI nationality mix	Years	Firm	Nationality	Outcome	As predicted?
Low, Moldova	1999	Farmaco	(Domestic)*	Breach	.
	2000-2002	Unistar Ventures / Air Moldova	German	Breach	No ^
	2007	Union Fenosa	Spanish	Settled	Yes
	2008-2009	SunCommunications	American	Settled	Yes
	2008-2011	Ascom (Anatol Stati)	(Domestic)	Breach	.
High, Romania	2003-2011	Bechtel	American	Breach	Yes
	2005-2007	OMV / Petrom	Austrian	Settled	No ^^
	2007-present	Rosia Montana Gold Corporation	Canadian**	Breach	Yes
	2009-2011	Sterling Resources	Canadian	Breach	Yes ^^

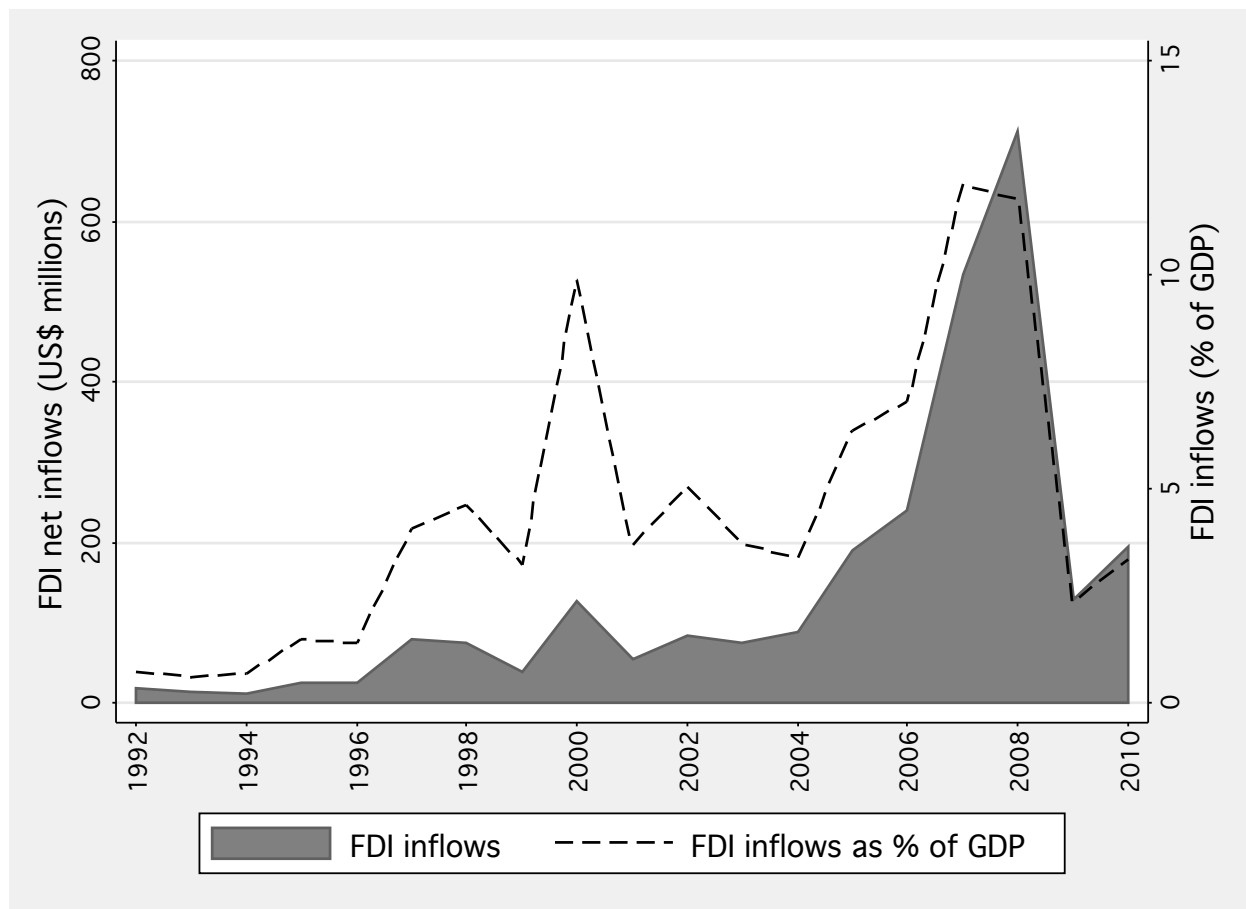
\* One owner held an American passport.

\*\* American capital added several years into the dispute.

^ Additional factor: Corruption.

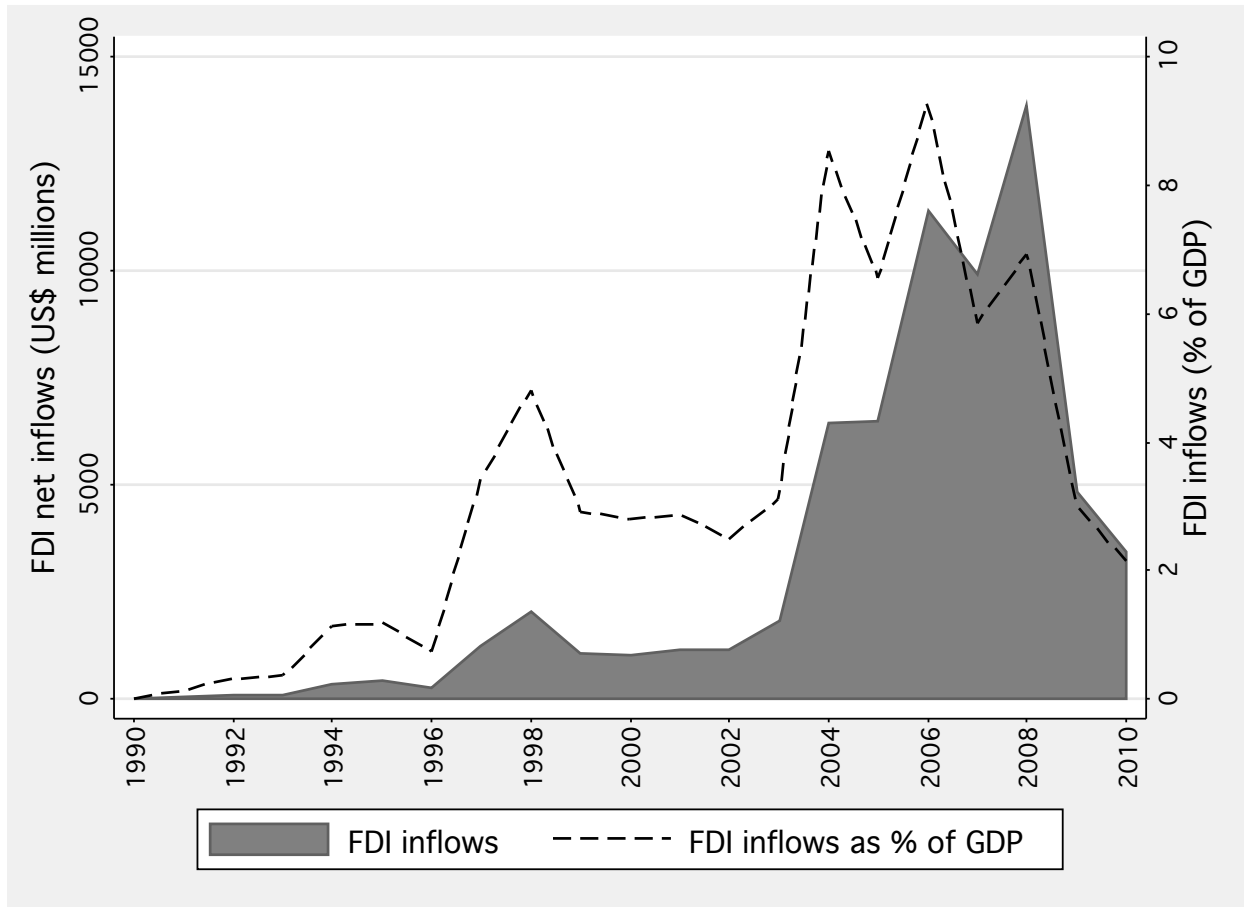
^^ Additional factor: Changes in coalition politics.

**Figure 1. FDI inflows and FDI as a percent of GDP in Moldova (1992-2010)**



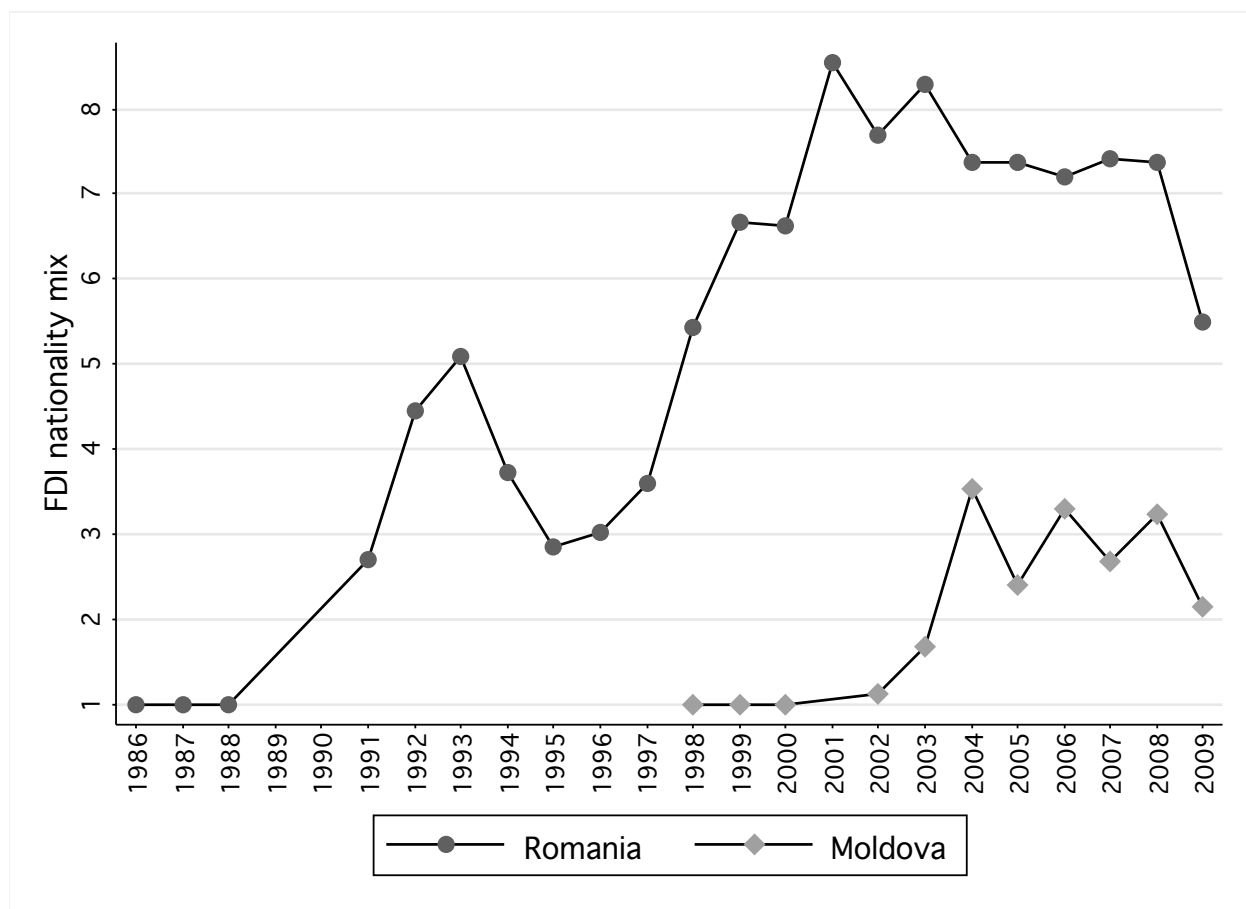
Sources: World Bank World Development Indicators.

**Figure 2. FDI inflows and FDI as a percent of GDP in Romania (1990-2010)**



Sources: World Bank World Development Indicators.

**Figure 3. FDI nationality mix, Moldova and Romania (1986-2009)**



FDI nationality mix =  $1/(s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2)$  where  $s_n$  is nationality  $n$ 's share of the annual FDI stock from OECD countries to country  $i$  in year  $t$ . See chapter 4 for details.

*Source:* Organization for Economic Cooperation and Development (OECD), FDI positions abroad.

## **Chapter 7: When Diversity Erodes Property Rights**

Arguments about nationality and economic globalization usually refer to the host country and the role its national borders play in a world of mobile capital. Many see multinational firms as “meta-national” – stateless multinationals unencumbered by their home country nationality. In contrast, the theory offered here takes seriously the bilateral relationship that is embedded in each investment transaction. The sanctity of contracts entered into by private investors is a function of the nationality of both the host country and the foreign firm. Far from having faded from relevance in a world of economic globalization, bilateral relations shape foreign firm and diplomatic interests in responding to government breach of contract.

Hosting more nationalities of investors gives a government more opportunities to access capital, allowing it to substitute for FDI exit and diversion by any particular national group. Consequently, the malleability of contracts between foreign firms and host governments depends on the set of foreign firms present in the host country at any one time. This means that FDI does not consistently do the work of increasing government respect for rule of law with regard to foreign firms themselves. So long as foreign firms of different national origins enter and exit a host country, variation in the aggregate FDI nationality mix generates varying constraints on a host government’s ability to breach contracts with foreign firms.

### **Nationality matters**

Often, foreign executives in emerging economies have particular, heartfelt interests in the future of the host economy and the well being of the local population. In interviews,

sometimes these individuals are more or less openly supportive of the government's rationale for breaking the contract of another foreign firm. Executives sometimes noted the naiveté of another firm's expectations around its government relations, or they accuse the firm of involvement in corrupt or illegitimate dealings. Others, in contrast, are adamantly in favor of foreign firm rights. These gritty executives are intensely sympathetic to the plight of their colleagues and friends at other firms, whether co-national or otherwise, and they express sarcasm and anger toward the host government on others' behalf. In other words, in Ukraine, Moldova, and Romania, as well as in interviews in the United States and Germany, individuals' emotions and perceptions of others' broken contracts varied – even among individuals working at co-national firms. Based on interviews, asymmetric information about the existence of breach is not what has generated variation in foreign firms' behavior. All executives interviewed for this dissertation were aware of and had opinions on broken contracts with foreign firms, one way or the other.

Irrespective of where their sympathies lay, however, executives make clear distinctions between their individual emotions and whether and how their multinational corporation chose to respond to a breach. It is costly to a firm to take actions that support firms with broken contracts and punish the host government. Drawing down investments following another's broken contract or taking a public stand against the host government has consequences for a firm's bottom line, not to mention the firm's own relations with the host government. Beyond bringing undue host government attention a firm's way, taking a public stand for another firm might cause a firm to lose customers in the host country or threaten relationships with local suppliers if, for example, the government's actions have popular support. For an individual in a confidential interview to express a personal opinion,



the stakes are low. For a firm to involve itself in another's fight, the stakes must be high enough to risk negative reprisals.

Home governments face an analogous calculus around getting involved in a firm's dispute. Such involvement can bring undue, negative attention to the bilateral diplomatic relationship and to that home country's investors more broadly. Home governments must weigh the benefits they might get in terms of strengthening their nationals' property rights abroad, and any direct benefits solving a particular dispute might generate, against the costs of spending limited political capital on this rather than other aspects of the bilateral relationship.

Nevertheless, co-national actors share a collective good in the protection of their property rights and the sanctity of contracts with the host government. Firms and a home government have incentives to take a stand on a co-national's behalf when benefits accrue not only to the firm with property at stake but to the group. Because fighting one firm's broken contract can strengthen co-nationals' property rights more broadly, and perhaps positively influence other aspects of the bilateral relationship, both firms and home governments can get on board.<sup>568</sup> As shown in chapters 5 and 6, co-national firms and their government have indeed come together to fight for their collective contract sanctity in response to government breach with a co-national. These efforts have been particularly successful when the government has fewer other national groups of firms on which to rely for capital access. Furthermore, even if a co-national firm is unwilling to engage in collective action to fight for its co-national's contract, it still has greater incentives to change its investment behavior in response than a firm of another nationality. As shown in

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<sup>568</sup> Co-national firms may also be motivated to act by implicit threats from the home government that, "if you don't join the cause now, we might not support you down the road."

chapter 4, firms of the same nationality are significantly more likely to draw down and divert FDI following evidence of co-national breach than firms of other nationalities.

In interviews conducted for this study, senior executives and, of course, diplomats referenced their and other firms' national origins over and over. When speaking to relations between foreign firms and government officials, nationality-tied considerations consistently trumped considerations about industry, for example. One American executive in Ukraine, reflecting on another American firm's dispute, declared, "There but for the grace of God go we." The two firms were in different industries, one producing for Ukrainian consumption and another for export, but the executive's understanding was that their common American origins transmitted shared contract risks. In Moldova, a prominent executive explained, "American investors have grown to understand the benefit of banding together." But it is American with American, Italian with Italian, Russian with Russian, Turkish with Turkish. As the theory here predicts, firms have found their strongest allies among their co-nationals. In contrast, the diverse investor environment in Romania is not conducive to such behavior. It is not that foreign executives there lack the same emotion as their counterparts abroad. As one French executive put it, "Maybe I'm personally sympathetic" about a Canadian firm's dispute with the Romanian government. "But," he went on, "I would never say that on the record, and the firm has no opinion."<sup>569</sup> Without a collective good of contract sanctity at stake, his firm remains indifferent to a government violation of another foreign firm's property rights. National boundaries differentiate risks of government breach of contract, and differential risks means differential willingness to respond to breach in ways costly to the host government.

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<sup>569</sup> Interview, French firm in banking sector, Romania.

## **Overcoming national differences?**

The issue examined in this dissertation is not how much capital a host government loses directly from a broken contract, when the counterparty withdraws. Rather, I have considered under what conditions host governments face a broader set of costly behaviors from foreign actors as a result of breach. This dissertation finds, first, that it is co-nationals undertaking costly behaviors following breach, and second, that host governments are more likely to choose breach when investors are more nationally diverse. Given this, what can savvy investors do to restore contract sanctity? In this section I both spell out logical implications of the theory for firm strategy and explore other possible characteristics around which firms might coalesce to strengthen contract sanctity.

One means through which a foreign firm could restore its contract sanctity would be for it to decrease the FDI nationality mix in the economy as a whole. Of course, the overall mix is exogenous to the individual investment decisions of all but perhaps the most massive foreign firms, limiting the applicability of this option. What individual foreign firms can more reasonably do is increase the national diversity of the capital that they command. Firms with claims on more home countries have access to more pools of co-national firms and more home governments that can come to their aid in contract disputes. In other words, foreign firms benefit from being “true” multinationals. This can come about as firms from different home countries merge or acquire each other, or when multinationals invest in a third country via a subsidiary in a second country. With ownership from France, the United Kingdom, and Luxembourg, and investing via its subsidiary in Germany, ArcelorMittal in Ukraine has been able to amass broad diplomatic support and collective action on its behalf (see again chapter 5). While the decision to enter into a merger or

acquisition is, in all likelihood, exogenous to any particular foreign investment in a politically risky country, it is not uncommon for firms to invest via second countries. All else equal, investing via a second country gives a firm more resources on which to draw to protect its contracts relative to single-nationality multinational corporations.

Conditions of true multinationality may also be created when firms from different home countries engage in consortia or joint ventures abroad.<sup>570</sup> Indeed, such ventures are common in some infrastructure and energy industries; the German firm Siemens and the American firm Westinghouse have co-invested in the Chinese nuclear industry, for example. Because such a consortium involves more than one collective good of contract sanctity, the host government has more at risk were it to violate contracts affecting two national groups. However, investors in many industries see joint ventures as stepping-stones rather than long-term investment strategies. Indeed, firms in joint ventures forego what Dunning sees as one of the main reasons firms engage in FDI: the control enabled by internalizing operations within the (single) firm.<sup>571</sup>

Perhaps obtaining financing or support from multilateral institutions can help individual foreign firms overcome the limits of their own nationality? Regional development banks like the European Bank for Reconstruction and Development, the Asian Development Bank, the Inter-American Development Bank, and the African Development Bank often provide financing to foreign firms and sometimes obtain equity in foreign-owned projects. The World Bank also provides financing and support through the International Finance Corporation and the Multilateral Investment Guarantee Agency. As

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<sup>570</sup> Joint ventures with local firms are also sometimes proposed as means to manage political risks, though domestic firms in emerging economy joint ventures have less reason to support their partner's property rights.

<sup>571</sup> Dunning 1980.

investors themselves, development banks have an interest in the sanctity of the contracts they enter into with host governments. Like any investor, they devote time and resources to fighting contract disputes with the government, and development banks can credibly commit to diverting or withdrawing other capital if their contract is violated.<sup>572</sup> The costs of losing access to development bank capital, which is often broadly deployed in an economy, might have more weight with the host government than the direct costs of breaking contracts with a wholly private foreign firm. This may help individual development bank-backed projects maintain their own contract sanctity.

Support from multilateral development banks does not, however, grant a firm true multinationality – and the shared risks and resources therein – in the way that ownership traced to multiple home countries does. Multilateral development banks' shareholders are national governments, and the banks ultimately make operational and investment decisions based on shareholders' preferences. For a development bank to take a stand on a dispute that did not involve the bank's capital, a sufficient plurality of shareholders would have to agree. As this dissertation argues, home governments have few incentives to go to bat for firms of other nationalities. This holds true when home governments are acting through representatives on a bank's governing board. Thus, a sufficient plurality would be difficult if not impossible to achieve.

The empirical record bears out the prediction that multilateral institutions are not means through which to mitigate the divisive effects of nationality. For example, in 1972 Congress passed the Gonzalez Amendment, which required US representatives at the World Bank and the International Development Bank to vote against loans to nations that

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<sup>572</sup> E.g. Interview, multilateral development bank, Ukraine.

expropriated US property without adequate compensation.<sup>573</sup> As expected by the theory here, no other government required its representatives to vote against loans following the expropriation of American property, and the Amendment did not dictate US representatives' voting if other nationalities' property were expropriated.<sup>574</sup> Nor do development banks coalesce around the broken contracts of other actors in the project finance industry. The European Bank for Reconstruction and Development, for example, has an explicit policy of not involving itself in other firms' disputes.<sup>575</sup> Respondents in Ukraine pointed out that multilateral development banks gained a competitive advantage once US firms had to turn to them, after the comparable US-specific institution OPIC was expelled from Ukraine (see chapter 5). Financing from multilateral institutions does not wipe away nationality-tied contract risks and resources, nor does it provide another axis along which foreign firms coalesce. As a result, while a particular foreign firm's contract sanctity may benefit from having multilateral financing, the presence of multilateral financing in an economy *per se* does not blur national differences to contract sanctity. National groups retain differential incentives to act in costly ways toward the host government, and they retain differential access to resources with which to fight contract breach.

The supra-national European Union has plans to unify legal protections for foreign firms coming from its member states, which would overcome one source of differentiation among contract risks: EU-origin national groups would share treaty rights and procedural

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<sup>573</sup> The Gonzalez Amendment came on top of the Hickenlooper Amendment of 1962 that required the President to cut off assistance to countries that expropriated US property without compensation (see chapter 2).

<sup>574</sup> To the extent that multilateral institutions are in fact dominated by one national voice, they would become a tool not of blurred nationalities but of that one national group. See Stone (2011) for such an argument about US control of the International Monetary Fund.

<sup>575</sup> Interview, EBRD, Ukraine.

resources. The Lisbon Treaty, which entered into force in 2009, extends exclusive European Union competence to FDI. Looking forward, the EU plans to conclude its own international investment agreements with third parties outside the EU. How EU-wide treaties would accommodate the dense network of 1500 existing member state BITs remains an open question.<sup>576</sup> However, if and when EU treaties come to replace BITs, the other elements that generate shared political risks among co-nationals – like bilateral histories with the host country and shared business practices among co-national firms – would continue to differentiate EU-origin investors along national lines. Moreover, the EU's political union is limited, and member countries continue to conduct their own diplomatic relations with other countries outside and inside the EU. Home governments would continue to have an interest in promoting their own firms' welfare, and they would continue to be disinterested in fighting contract breaches faced by firms of other nationalities. In short, while EU developments have the potential to change the international legal protections available to firms from its member states, other forces that bind co-national firms together and distinguish the contract sanctity of firms of other nationalities would continue to be at play. EU countries would still constitute different home countries in terms of a host country's FDI nationality mix.

Although a firm's contract sanctity may suffer from a high FDI nationality mix, it is possible that a countervailing axis of differentiation among foreign firms might work in favor of (or against) that firm's contract sanctity. As discussed in chapter 2, previous work has taken industry into consideration and predicted that firms with immobile assets face a higher likelihood of contract breach. It is possible that firms in a particular industry take

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<sup>576</sup> Under international law, parties would retain rights under member state BITs for up to 20 years after a BIT is withdrawn or superseded by EU law. "The EU Approach to International Investment Policy" 2010: 8.

co-industrials' contract sanctity into account in their investment decisions, or that firms with immobile assets take investment cues from each other's host government relations. As far as the exercise of voice, however, in the course of researching this dissertation I found little evidence of collective action within an industry on behalf of a particular firm's broken contract. Firms across immobile industries, like oil and gas, mining, infrastructure, and retail, had sometimes attempted but ultimately failed to organize collective lobbying efforts. Thus, it may be that firms in the same industry or with similar asset mobility exit in response to a similar firm's broken contract, but such groups of firms lack the sorts of protest mechanisms that firms of the same nationality can use to bolster contract sanctity.<sup>577</sup>

Asset history could be another characteristic that differentiates firms' responses to a given government breach of contract. While some foreign investors build greenfield, or from-scratch, facilities in host countries, others merge with or acquire existing domestic businesses or buy previously state-owned property. Public and political feeling about the prior exploitation of particular assets and prior owners may reasonably affect a foreign investor's contract sanctity. If one investor's asset is not in the public eye and has no history of controversy – or no history at all – then government threats against high-profile foreign-owned assets are unlikely to incentivize it to draw down investments. In contrast, investors into previously state-owned assets have a written contract with the host government, and an implicit obligation to the host government and domestic polity, that is similar to each other and different from other foreign firms. Breach of a privatization contract may thus elicit FDI drawdown from the subset of investors into privatized assets

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<sup>577</sup> Quantitatively and qualitatively, this dissertation has shown strong effects of nationality when controlling for industry.



but indifference from others. Yet, as with industry and asset immobility, a common asset history does not in itself provide firms with resources to exercise voice, especially not in the way that nationality provides diplomatic support and, often, pre-established nationality-tied investor associations. In the context of continuing privatization processes in emerging economies worldwide, exploring the implications of asset history for foreign firm-host government relations is all the more important.<sup>578</sup>

Nevertheless, having controlled for these other potential sources of heterogeneous foreign firm responses to broken contracts, this dissertation goes to show that firm nationality is a robust source of variation in foreign firm behavior. Particular firms can indeed gain additional individual protections from contract breach by acquiring true multinationality, leveraging financing from multilateral institutions, or using supranational legal protections. These strategies do not, however, erode the basic argument presented here: actors of different nationalities are unlikely to respond to a broken contract in ways costly to the host government. When the host government breaks a foreign firm's contract, it is co-national investors that are more likely to draw down investments as well as protest breach in hopes of restoring contract sanctity to the co-national group as a whole.

## **When host governments are autonomous**

At times when FDI nationalities are more diverse, the theory presented here bodes well for emerging economy governments' autonomy. Considering the emergence of multinational corporations in more and more home countries over the twentieth century,

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<sup>578</sup> Time controls in statistical analyses account for waves of privatization in emerging economies. Privatization-based coalitions were considered and rejected as an alternative explanation for cases in chapters 5 and 6.

as described in chapter 2, we can reasonably expect that host governments will in the future face more, rather than fewer, moments at which FDI nationality diversity is high. What might be the effects of more and more instances of host government autonomy with respect to foreign firms? What does the sometimes incidence of government breach of contract mean for the emergence of good governance and positive development outcomes in emerging economies?

A government's commitment to its own contracts, both domestic and foreign, is a key element of rule of law and what we know as good governance. By acting within the rules of the society it governs, rather than above those rules, governments can provide domestic and foreign investors confidence that the government will in the future keep its hands off investments made today. From a foreign firm's point of view, contract sanctity, rule of law, good governance, and normatively positive economic outcomes go hand in hand. But from a host government's or a host society's point of view, foreign firms' contract sanctity need not automatically suggest good governance or normatively positive economic outcomes.

Parts of the empirical record suggest that a government's choice to break contracts with foreign firms may in fact reinforce good governance and responsible economic development. This dissertation has examined Ukraine's broken contracts with Russian and Cypriot investors, contracts which Ukrainian domestic society saw as relics of a different era in which "Wild East" capitalists ran roughshod over the state (see chapter 5). One could argue that breaking those non-transparently negotiated contracts, in which state assets were sold at rock-bottom prices, was better for the Ukrainian political economy than honoring them would have been. Chapter 6 discusses how Romania has broken its

obligations to a Canadian firm looking to develop what would be Southeast Europe's largest goldmine. Many citizens and non-governmental organizations celebrate this breach as a commitment to improved environmental regulation, especially poignant after several mining-related ecological disasters in the region. From this point of view, a previous government made a mistake in allowing the investment to go forward, and the new government has rightfully reasserted the country's principles and proper regulatory standards. Breach in this case is a means by which Romania is "racing to the top" in its *de facto* if not *de jure* environmental, health, and safety standards. These two conflicts provide just a small insight into the narratives host governments construct around foreign firms' contracts, narratives which often make normative claims about fairness, justice, and equity that some observers might see as sufficient justification for breach.

On the other hand, observers might say that governments always have the incentive to tell a good story, and there is no reason to presume that the exercise of host government autonomy in all or any breach is normatively positive. Autonomy means freedom, and free choice can result in bad outcomes. Breach motivated by corruption, for example, is unlikely on its face to generate positive social effects. Political factions can wield contract sanctity as a tool for personal gain, leaving the effects of variation in contract sanctity on the political economy of secondary interest at best. In chapter 6, for example, we saw that breach and contract sanctity in Romania were tied up with animosity toward actors in the previous administration. Of course, breach of contract with foreign firms does have costs: direct costs, the loss of co-national capital, and potential diplomatic penalties. Even if a normatively positive short-term benefit resulted from a broken contract, one could reasonably argue that these costs will do more to erode development goals in the long run.

In the case of Argentina's non-payment of \$300 million in compensation to two US multinational corporations, six years late as of 2012, the government has explained that breaking contracts was necessary to pull it out of economic crisis in the early 2000s. One might normatively agree with that justification in isolation. But non-payment has resulted in the US suspending trade benefits for Argentina in 2012, benefits that allowed Argentina's exporters to avoid paying US\$17.3 million in duties in 2011.<sup>579</sup> Whether the circumstances in the early 2000s justify this penalty on Argentine exporters today is an open question.

If we allow that positive outcomes for the domestic political economy can emerge from government breach of contract, or at least that the normative status of breach can be ambiguous, then there is a flaw in contemporary development policy. What was in the early 1990s a consensus on a list of institutions necessary for economic development has been whittled down to a focus on protecting property rights above all else.<sup>580</sup> But if host governments can achieve normatively positive outcomes both under contract sanctity and, sometimes, when breaking contracts with foreign firms, then foreign firm's property rights should not be prioritized above all else. Although radical, the theory and evidence here justify some flexibility in government commitments to property rights. A new approach to development policy would be to allow – even facilitate – breach “for the better” and deter breach for the worse. Reconsidering some of the sovereign rights emerging economies have sought to encode in multilateral agreements, as spelled out in chapter 2, could be a way to make this feasible.

Nevertheless, the theory and evidence presented here on the effects of variation in the constraints on breach have little to say as to when breach might be “for the better.”

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<sup>579</sup> Palmer, Doug. “Obama says to suspend trade benefits for Argentina.” *Reuters*: 26 March 2012.

<sup>580</sup> Schleifer and Vishny 2002, Rodrik 2007, de Soto 2000.

There is little reason to expect the normative status of breach to be correlated with the diversity of foreign firm nationalities in a host country. Rather, recognizing that foreign firms do not form a cohesive interest group allows us to better understand how host governments' and foreign firms' conflicting incentives regarding contract sanctity play out. Understanding the effects of this interplay on development outcomes of interest is an important next step to exploring the possibly perverse effects of prioritizing property rights when, anecdotally, it appears that good can come from breach.

## **Conclusion**

For host governments seeking foreign capital, the most damning choice they can make is to break a contract with a foreign firm. This statement, while capturing the conventional wisdom, must in fact be made conditional. When a government hosts very few nationalities of foreign firms, the costs of breach of contract with a particular investor may indeed close the spigot of FDI. But this is not because all foreign firms would divert or draw down their investments. FDI closes off because a group of co-national investors exits and exercises voice together with their diplomats, and those investors represent a significant proportion of the host government's access to capital. Government breach of contract is significantly less damning, however, when a host government faces a great diversity of foreign firms. In that case, the flow of capital from other national groups remains even when the contract sanctity of one group is threatened.

By disaggregating what is usually seen as a monolithic bloc of foreign investors and building a theory up from the level of the firm, this dissertation has shown that foreign investors remain divided even when one nationality is conquered. Using firm-level analysis

to explain aggregate variation is an important step forward for work in international political economy. Indeed, using both quantitative and qualitative evidence, this dissertation has shown that firm behavior, diplomatic reactions, and host government decisions ultimately account for aggregate levels of breach in predictable ways, both over time and across countries.

Foreign firms' reliance on creative means to protect their interests *ex ante* facilitates continued FDI into risky emerging economies. Yet with investment coming from more and more home countries, host governments have the opportunity to breach contracts in creative ways. The decline of nationalization and rise of creeping expropriation, in forms like regulatory taking and forced renegotiation, speak to the continued ability of host governments to take advantage of the space provided by a high FDI nationality mix. And what an advantage it is. When host governments breach contracts with certain foreign firms and are met with indifference by others, it follows that investor diversity can be a liability to investors while providing an opening for host governments to prioritize other goals over the property and preferences of foreign capital.

## **Appendix: Qualitative data and methods**

From 2009 to 2012, I conducted over 130 interviews in Ukraine, Moldova, and Romania, with supplementary interviews in Germany and the United States. Interview subjects included local heads of multinational subsidiaries from 19 different home countries; government officials responsible for relations with foreign firms; heads of foreign investor associations; lawyers and other legal professionals involved with contract disputes and investment treaty-based lawsuits; regional business journalists and analysts; and representatives from organizations interested in foreign investment and the rule of law, including the IMF, the European Bank for Reconstruction and Development (EBRD), the World Bank's International Center for the Settlement of Investment Disputes (ICSID), the Organization for Security and Cooperation in Europe (OSCE), and various American and other national organizations. Interviews typically ran from one and one-half to three hours. The purpose of these interviews was, first, to establish a robust sample of well-known contract disputes as well as investors' experiences around the maintenance of contract sanctity. Second, interview evidence allowed me to reconstruct the narratives around instances of contract breach, moments when host governments stepped back from breach, and the government's maintenance of contract sanctity even when under pressure to do otherwise. I supplement interview data with publicly disclosed investment arbitration records from local and international tribunals; coverage of contract disputes in local media, including local media written for an expat audience; international media coverage; testimony given to and legislation written by the US Congress; official firm and government communications; and secondary sources.

In the core set of interviews in the region, I spoke to the local CEO or Managing Director of typically large multinational corporations involved in manufacturing, banking and finance, business services, natural resources, food and agriculture, logistics, telecommunications, and trade.<sup>581</sup> Targets were deliberately drawn from a variety of industries, including natural resources and infrastructure, as those industries are conventionally thought to be prone to contract breach because firms have a difficult time credibly threatening exit. I chose to speak to top executives, because these are the individuals closest to investment decisions whether they are made locally or in the head office. Additionally, these individuals are most responsible for the firm's overall strategy within a host country. Their insights into their own and others' broken or disputed contracts, therefore, are most relevant to the possibility of changes in investment plans or participation in collective action.<sup>582</sup>

I targeted firms in Ukraine, Moldova, and Romania that had been directly involved in public contract disputes, as well as prominent investors that did not have public records of contract disputes or breaches. I define "prominent" as those firms often commented upon in local media, on the board of investor associations, or with brands and products that make them well known to actors in the domestic economy and often to the domestic public itself. Interviewees were asked both about their own relations with the government (and possible broken contracts) and about a list of other firms' broken contracts that had been publicized in recent years.

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<sup>581</sup> Ukraine: 22 firms, Moldova: 14 firms, Romania: 8 firms. Again, interviews with local foreign investor organizations in each country allowed me insight into the experiences of a greater variety of firms.

<sup>582</sup> Multinational executives are well known to each other in each of these countries; often, respondents referred me to individuals who I had previously interviewed or, unprompted, identified individuals whose arguments conflicted with their own.



Government interviewees included those at investment promotion agencies, officials with finance ministries, former diplomats, and elected politicians. Local stringers for international newspapers, think tank representatives, and scholars provided third party insights into the conduct and progress of particular contract disputes and breaches. Additionally, I spoke to partners at seven law firms (some of which are multinational corporations themselves) who had represented the host government and/or the home government in international legal proceedings; some of these partners had also attempted to organize class action lawsuits against these governments.

In using interview evidence to narrate episodes in host government-foreign firm relations, I take care to separate interview respondents' frustrations with government in general from reactions to specific violations of foreign firm property rights. For example, a firm may be frustrated by constant visits from tax authorities who are intent on finding the smallest discrepancy in the firm's books. That situation is not the one under study here. Rather, a contract breach occurs when the government unilaterally cancels tax breaks that are part of the firm's investment contract, for example.<sup>583</sup> That said, the line between frustrating circumstances and contract breach is not always clear. In my analysis, I use respondents' own understanding to draw the line beyond which frustrating circumstances become contract breach. I found these understandings to be essentially uniform across investors targeted by a given event or observing that same event.

In the dissertation's qualitative analysis, I focus on public disputes, which vary in whether they become a breach or not. At moments when a host government and foreign

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<sup>583</sup> This has happened both in Ukraine and Moldova when, after some years, those governments cancelled privileges afforded firms that had invested in special economic zones. Romania has faced international litigation after withdrawing contracted tax incentives, although the European Union supported Romania's actions. See chapters 5 and 6 for discussion.

firms are in a public contract dispute, we can assume that the threat of investor exit was insufficient to wholly deter the conflict. It is in these moments that I predict collective co-national efforts to play an important role in deterring government breach, particularly in times of a low FDI nationality mix. The alternative hypothesis against which my hypothesis competes is that cross-national actions by foreign firms are better able to explain outcomes of disputes than co-national efforts. The process tracing employed in chapters 5 and 6 is an appropriate technique to account for the presence or absence of co-national action and to make inferences about its effectiveness. I did not trace disputes that resulted in public international investment arbitrations (IIAs), or lawsuits brought by foreign investors against the host government under the scope of international treaties. While I used these lawsuits as one reasonable indicator of contract breach in the quantitative analyses in chapter 4, examining foreign firm-government interactions in other cases allows me to test the theory as it relates to disputes that do not reach the peak of the international legal system.

All interview subjects were promised complete confidentiality. Identifying characteristics, such as industry and sometimes nationality, have been removed (but not changed). Information on named firms comes from publicly available sources.

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