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Excerpt
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Nationality and Leverage in a Globalized World

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

THE SHIELD OF NATIONALITY

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

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

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

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

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

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

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

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

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

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

DO MULTINATIONAL CORPORATIONS EVEN HAVE NATIONALITIES?

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

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

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

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

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

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

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

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

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

"ROOM TO MOVE"

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

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

[24] Access to FDI is not only about capital, but also about the taxes, technology, employment, and spillovers that may accompany it. However, I will use "capital access" as a shorthand in this book.
[25] Mosley 2000, 2003, 2005.

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

WHY GOVERNMENTS BREAK CONTRACTS

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

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

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

[26] Rodrik 2011.

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

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

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

BREACH IN ARGENTINA

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

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