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# Investor–State Disputes: When Can Governments Break Contracts?

Rachel L. Wellhausen<sup>1</sup>

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## Abstract

Since 1990, governments around the developing world have broken contracts made with multinational corporations (MNCs), but the incidence of breach varies across countries and over time. I argue that shared firm nationality is a key determinant of contract sanctity. MNCs are likely to divert investments or exit in response to breach with a firm of the same nationality but unlikely to react in ways costly to the host government otherwise. At the level of the economy as a whole, host governments gain permissive space to trade-off among national groups of investors when a greater diversity of foreign direct investment nationalities is present. I use national-, firm-, and dyadic-level data from 1990 to 2008 to demonstrate nationality-tied firm responses to breach. Counterintuitively, deeper integration with more nationally diverse MNCs enables more breach, as governments gain space to prioritize other goals over the property and preferences of foreign capital.

## Keywords

foreign direct investment, multinational corporations, political risk, nationality

From a multinational corporation's (MNC's) point of view, rule of law in a destination country hinges on the sanctity of contracts with the host government. However, since the 1990s, the vast majority of governments around the developing world have at one

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<sup>1</sup> Department of Government, University of Texas at Austin, TX, USA

## Corresponding Author:

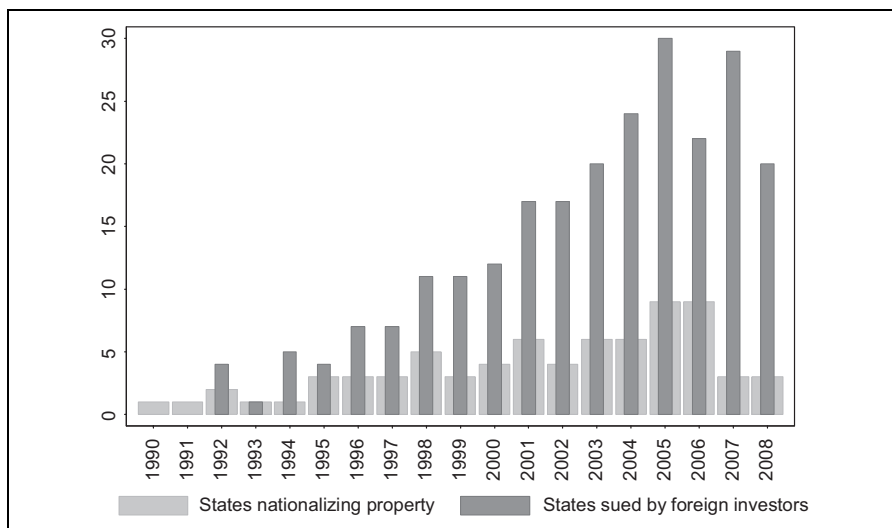
Rachel L. Wellhausen, Department of Government, University of Texas at Austin, 158 W 21st St., Stop A1800, Austin, TX 78712, USA.

Email: rwellhausen@utexas.edu

time or another violated MNCs' contracts. Host governments break formal and informal contracts with MNCs by forcibly transferring ownership of foreign property through nationalization and expropriation. Governments also break contracts and devalue foreign holdings through forced renegotiations, discriminatory policy changes, and other undue interference with foreign firms' operations in actions known as *creeping expropriation* (Kobrin 1982). This is despite the fact that we expect governments in poor countries to do everything possible to reassure foreign firms and, at a minimum, to respect the contracts they make with foreign firms lest foreign capital flee (e.g., Shleifer and Vishny 2002; Rodrik 1997, 2011; Strange 1996). Nevertheless, governments do not always break contracts. In a world where all actors, governments or otherwise, are interested in sometimes violating agreements, this article identifies and explains the varying constraints host governments face to honor or break contracts with MNCs.

I find that the nation-state is embedded in economic globalization at both ends of the investment transaction. National governments sometimes renege on commitments to MNCs, and MNCs' national origins influence the risk that host governments will renege. Many argue that the nationality of MNCs is an "outdated notion" (Stopford 1998; Kobrin 2001). But nationality constrains firms' legal rights and shapes their investment behavior. As a result, *conational* MNCs are likely to worry that their conational's broken contract is a forewarning of their own problems, making them more likely to divert their investments in response. In contrast, firms of other nationalities are likely to meet the broken contract with what looks to the host government like indifference. Moving to the level of the economy as a whole, the implication is that a government host to more nationally diverse foreign direct investment (FDI) gains the permissive space to trade-off across national groups and break contracts while maintaining (though not maximizing) capital access. Counter-intuitively, economic integration with a greater variety of firms of different nationalities need not augment foreign firms' property rights protections and can instead diminish them.

In what follows, I describe variation in government contract sanctity with MNCs across the developing world and review the limits of literature on regime type and industry to explain this variation. I then use national-, firm-, and dyadic-level data from 1990 to 2008 to conduct tests of the theory and its implications. First, I develop a new measure of the mix of FDI nationalities in a host country based on a Hirschman–Herfindahl Index (HHI) and use it to test the hypothesis that higher FDI national diversity increases the likelihood of contract breach. Second, I analyze firm responses to World Bank Enterprise Surveys to demonstrate that foreign firms report more breach of contract in countries with high FDI national diversity. Third, I test the underlying mechanism that one MNC's broken contract affects conationals' (but not others') investment decisions, using dyadic FDI flows from advanced to developing economies. I conclude by emphasizing what nationally mediated firm responses to government breach of contract mean for our understanding of economic globalization. More diverse FDI nationalities reinforce host governments' autonomy—including the autonomy to act contrary to the property rights of global capital.



**Figure 1.** Nationalizations of foreign property by and public international investment arbitrations (IAs) against developing countries (count).

Source: Minor 1994; Hajzler 2012; The United Nations Conference on Trade and Development (UNCTAD), Author's records.

## Breach of Contract

Since 1990, MNCs in industries as varied as utilities, oil and gas, real estate, banking, services, transportation, manufacturing, agriculture, mining, telecommunications, media, metals, and trade have sued developing country governments in what are known as *public international investment arbitrations* (IAs). Figure 1 reports the number of developing countries sued annually, which has increased rapidly through the 2000s as more MNCs started to make use of the right to sue that Bilateral Investment Treaties (BITs) give them.<sup>1</sup> Figure 1 also tracks the number of states nationalizing property—a particular type of breach of contract that remains prominent despite predictions to the contrary (Minor 1994). Offenders make odd bedfellows: they include countries with much variation in economic health, from Egypt to sub-Saharan African nations; resource-rich or resource-poor countries, like Venezuela or Costa Rica; and transition economies keen to establish themselves as market players, like the Czech Republic and Hungary. Yet, the propensity of governments to break contracts varies both across and within countries over time. In Ukraine, for example, the government expropriated twelve American firms in the 1990s but respected contracts following disputes with American, Norwegian, and Russian firms in the late 2000s, even after the political scene turned turbulent (Wellhausen 2013).

Why do governments break contracts? Host governments and their constituent parts seek to remain in office and otherwise derive benefits from their positions of authority.

In this pursuit, breach of contract has been a means for governments to achieve a variety of goals, including raising revenues; addressing asset- or sector-specific concerns; catering to domestic interests; and conducting foreign policy. For example, Argentina broke dozens of foreign contracts to stay afloat during its 2002 default and surrounding financial crisis; Ecuador has pursued an economic nationalist agenda, expropriating MNCs in natural resources; Romania effectively updated its environmental regulations by revoking the permits of a Canadian mining firm; and bilateral political tensions contributed to the Lithuanian government breaking contracts with a Russian firm in favor of Polish investors. Of course, breach can also be a means of carrying out corruption—or simply getting out of a deal that turned sour. A variety of new research explores the motives governments have in breaking contracts (Robertson and Teitelbaum 2011; Albertus and Menaldo 2012; Fails 2012). However, given the multitude and relative constancy of temptations to breach (whether we speak of cell phone contracts or privatizations), this article aims to understand the circumstances under which governments find the permissive space to carry out breach.

In considering MNCs' contract sanctity, recent literature on FDI focuses on host country governing institutions. MNCs are expected to enjoy more investment security either in democracies as a whole (Jensen 2006, 2008; Jensen and Young 2008) or in countries with strong property rights and a constrained executive (Li and Resnick 2003; Humphreys and Bates 2005; Li 2009). Some scholars focus on the effects of natural resources and legal commitments. Cai and Treisman (2005) model that poorly endowed states have incentives to give up on investment attraction as a lost cause and focus on predation instead (cf. Jensen and Johnston 2011). Nevertheless, in the last decades, even the poorest countries have signed BITs that codify MNCs' rights in hopes of attracting FDI (Elkins, Guzman, and Simmons 2006; Jandhyala, Henisz, and Mansfield 2011). Much research shows, however, that the connection between BITs and FDI is weak at best (Sauvant and Sachs 2009), making BITs alone a poor explanation for variation in contract sanctity.

Literature on the "obsolescing bargain" focuses on foreign-owned assets. The obsolescing bargain describes the situation where an MNC holds the upper hand in negotiations with a host government *ex ante*, but the firm's investment requires such high sunk costs that exit from a committed investment is prohibitively costly (Vernon 1971). In these cases, host governments have leverage to break contracts, because the MNC's asset immobility makes the firm's threat of exit no longer credible. In general, the obsolescing bargain has been operationalized in terms of industry, applied most often to investments in oil, natural resources, and metals, as well as infrastructure investments and other site-specific ventures that offer owners concentrated rents and are easily seized (Frieden 1994). While industry continues to be an important characteristic in understanding political risk more broadly (cf. Henisz 2002), it alone is insufficient to explain variation in contract sanctity. Coindustrials' willingness and ability to act in ways costly to the host government following breach are inevitably tempered by the tension between competition and collaboration: one firm's expropriation can be another firm's opportunity, which makes it *ex ante*

unclear whether coindustrial firms would draw down or even increase investments following a coindustrial firm's broken contract.

Most importantly, arguments about both regime type and industry overlook how the costs of breach aggregate. Does a breach of contract with one MNC increase risks to all MNCs? Jensen and Johnston (2011) imply that the answer is yes: after expropriating one firm, the government has more resources with which to offset costs incurred by future expropriation. In contrast, I argue that a given expropriation does not suggest increased risks to the contract sanctity of all MNCs.

MNCs observing a host government's breach of contract with another MNC face the question, Are they next, or can they safely ignore that firm's broken contract? Navigating an information-rich world, firms logically collect and employ information most relevant to their own expected returns (Mosley 2005, 742). While a variety of characteristics may make MNCs more or less sensitive to each other's contract disputes, I focus on one key, underexplored characteristic: shared firm nationality. In short, conational firms share a collective good of contract sanctity, which makes them more likely to respond in ways costly to the host government—in particular, through FDI drawdown or diversion—when a conational's contract is broken than otherwise.<sup>2</sup> Variation in MNC nationality helps to explain why host governments, of all stripes, sometimes breach contracts with MNCs in a variety of industries.

Shared nationality generates a collective good of contract sanctity in part because nationality forms the cornerstone of BITs, which embed investor national origins in their legal recourse around contracts. The operation of the BIT to which a firm has access is more relevant than that of other BITs, as the treaties vary on important elements such as host government obligations to MNCs and access to third-party arbitration (Allee and Peinhardt 2010; Blake 2010).<sup>3</sup> Because of BITs, nationality determines the scope (or presence) of a host government's international legal commitments and the resources on which firms can draw. Firms thus have more incentive to adjust their behavior based on conationals' legal experiences than otherwise.

Even before bilateral treaties reinforced nationality-specific contract sanctity, MNCs long felt the burden or blessing of bilateral politics. The political underpinnings of investment decisions are most explicit when state-owned enterprises act as foreign investors, as these firms have the flexibility to sacrifice profit maximization in favor of foreign policy goals (Knutsen, Rygh, and Hveem 2011). Scholars also find that dyadic security actions have significant effects on dyadic FDI flows (Biglaiser and DeRouen 2007; Li and Vashchilko 2010; Biglaiser and Lektzian 2011), and firms increase their required return on investment when dyadic diplomatic tensions arise (Desbordes 2010). MNCs of different nationalities face different hurdles or gateways to legitimacy with the host country polity and government and, consequently, to contract sanctity (Zaheer 1995; Hymer 1976).

Following North (1990), scholars find that firms of the same nationality operate in similar ways abroad, thanks to the formal and informal institutional constraints of their country of origin. When home and host countries are more culturally similar, MNCs rely less on codified contracts and more on shared norms and tacit

knowledge, which can lower transaction costs and differentiate their contract sanctity from that of firms entering into arms-length contracts (Williamson 1979; Holburn and Zelner 2010). Additionally, similar conational business practices help to generate nationality “brands” that can make host governments expect more developmental benefits, like technology transfer and the growth of domestic spin-off firms, from some nationalities’ FDI than others. This too can differentiate contract sanctity, depending on whether such benefits arise or not.

Because of these similarities in legal resources, home–host country relations, and business form, conational firms are the ones more likely to respond in costly ways to a given broken contract. Moreover, should a dispute arise, home country diplomats are a key resource for foreign investors. If the risks of lost capital and diplomatic conflict fail to deter breach, adverse government actions signal that the government is willing to renege on contracts with other firms of that nationality.

With conationality a key determinant of MNCs’ sense of contract sanctity, what about firms that have claims on multiple home countries? Mergers and acquisitions leave some MNCs with more than one set of national ties, and sometimes firms invest in third countries via second-country subsidiaries or tax havens. Such MNCs are often seen as the world’s most powerful holders of leverage over host governments. But far from existing outside of national boundaries, these firms’ contract sanctity is still determined by national origins and (more than one set of) bilateral relations. For example, the set of MNCs using an intermediate home country must deal with the negative publicity such a decision can generate in the host country; those investors also share access to resources like an intermediate home–host BIT. “True” MNCs are also more likely to drawdown FDI in response to (any of their) conationals’ broken contracts than otherwise.

**Hypothesis 1:** All else equal, MNCs of the same nationality are more likely to divert or draw down FDI following a government breach of contract than otherwise.

Foregone capital from conational firms can generate real constraints on host government behavior. The catch is that the power of one national group to solidify its contract sanctity is mitigated by other national groups’ likely unchanged investment behavior. To the host government, unchanged behavior is observationally equivalent to indifference to breach. Facing this seeming indifference, the host government can trade-off one nationality’s contract sanctity against other sources of current and future FDI. This is because, in the aggregate, increased FDI national diversity means that the host government has less current and/or future access to capital at stake in any one incident. Accordingly, a greater diversity of FDI nationalities in the host country increases the government’s power to break contracts with some firms but retain access to capital from others. Thus, the theory here implies that permissive space exists to expropriate and, moreover, that foreign direct investors generate it themselves.

**Hypothesis 2:** All else equal, a government host to a greater diversity of FDI nationalities is more likely to break contracts with MNCs.

## FDI National Diversity

To calculate FDI national diversity, I use an HHI, originally an indicator of industrial fragmentation. For ease of interpretation, I use an inverse HHI:

$$\text{Inverse HHI}_{it} = 1 / (s_{1t}^2 + s_{2t}^2 + s_{3t}^2 + \dots + s_{nt}^2), j = 1, \dots, n \quad (1)$$

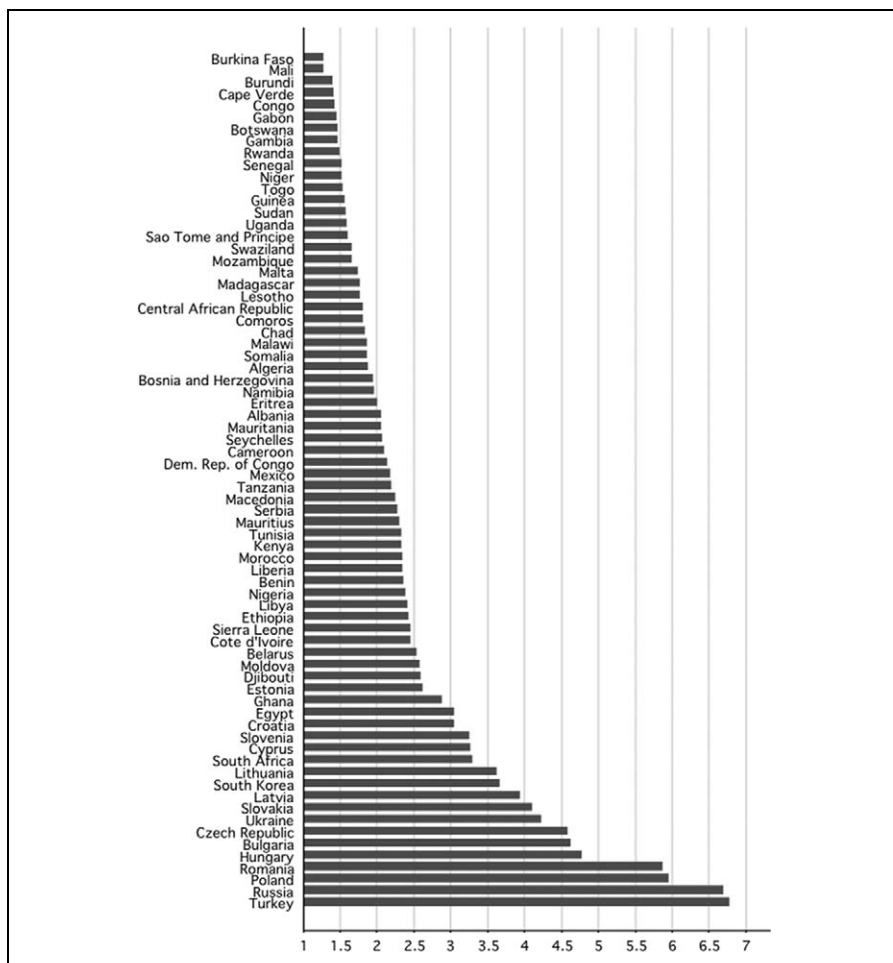
where  $s_{jt}$  is nationality  $j$ 's share of the annual FDI stock in country  $i$  in year  $t$ .

FDI national diversity 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. Even if a given national group invests a small amount of FDI today, the fact that MNCs of that nationality have already entered makes it a more reliable source of capital tomorrow than another as yet unrepresented nationality, if only because reinvestment is an increasingly important component of FDI flows. When FDI is evenly distributed across firm nationalities, the nationality mix is high and the likelihood that government breach of contract will take place somewhere in the economy is high. When FDI is unevenly distributed, governments face high immediate costs to breach with large national groups, while breach with small national groups threatens important sources of future FDI inflows that could benefit governments by increasing the nationality mix.<sup>4</sup> FDI national diversity can change with a change in circumstances unrelated to nationality per se, as the firms responding to the many determinants of FDI are unlikely to be evenly distributed across national groups. Through investment law, governments can have some influence over FDI national diversity; however, in a world of liberalized capital flows, this is expected to be limited.

In this article, values on *FDI national diversity* capture the effective number of Organisation for Economic Co-operation and Development (OECD) nationalities present in a country-year.<sup>5</sup> Figure 2 reports the average FDI national diversity, from 1990 to 2008, in seventy-four available developing countries. The variable ranges from a value of 1 to 10.6 (Ukraine in 2003), with a sample mean of 2.9 effective nationalities per country-year.<sup>6</sup> Turkey has the highest average value (6.8 effective nationalities). Consistent with gravity model expectations, countries closer to Europe tend to have more diverse nationalities of investors present.<sup>7</sup>

Issues with the OECD data generate a downward bias on the hypothesized positive effect of FDI national diversity on breach. First, FDI country of origin is based on the residence of an economic entity, as reported by national statistical offices. This means that firms are generally tied to what is understood to be their home country rather than sites of mere legal incorporation.<sup>8</sup> If one contends that some FDI may nevertheless be assigned to tax havens and that such FDI carries fewer nationality-specific contract risks, then I dilute the FDI national diversity measure. Further, attributing "true" MNCs to one nationality underestimates the spread of FDI across national groups. Finally, OECD data do not capture the growing segment of South–South FDI in the world. But omitting FDI originating in other home countries again causes me to underestimate FDI national diversity, so long as a small number of South investors do not overwhelm the distribution of OECD-origin MNCs. In





**Figure 2.** Average FDI stock national diversity, available developing countries (1990–2008). Source. OECD FDI positions. Author's calculations.

Note. FDI = foreign direct investment; OECD = Organisation for Economic Co-operation and Development.

support of this assumption, the correlation between this article's OECD-based measure and a world-based measure of FDI national diversity in 2009 is 0.64.<sup>9</sup>

Is FDI national diversity merely a measure of the mix of FDI by industry? Nationality–industry FDI data are notoriously scattered. Nevertheless, I generate an FDI industry mix based on investments from European countries in 2003 through 2009 in six industry categories: agriculture, oil and gas, manufacturing, mining, real estate, and services (Eurostat). The correlation between the industry HHI and the nationality HHI, for 880 observations across thirty-nine available countries, is very low (0.04).

## National-level Analyses: More Diversity, More Breach

I begin by testing Hypothesis 2: an increase in FDI national diversity increases the likelihood of breach in a country as a whole. First, I take as the dependent variable the propensity for a host government to break contracts, measured at the national level.

### *Measuring Variation in Contract Sanctity*

An appropriate dependent variable must be derived from the risks facing any foreign firm and not just foreign firms of a particular nationality. However, only selected contract breaches are elevated to the public record and that selection mechanism is rather opaque. As a result, I use several measures to get at breach over time: political risk insurance pricing; and two measures of investors' aggregate expectations of the government's propensity to breach (with firms of any nationality).

In model (1), the dependent variable comes from data on the pricing of political risk insurance for foreign investments. The Belgian Export Credit Agency (Office National Du Dueroire [ONDD]) calculates risk ratings to capture its expectations that government actions will lead to political risk insurance payouts. Jensen (2008) documents that non-Belgian risk evaluation firms use the ONDD data, indicating that users expect ratings to capture a common and not Belgian-specific level of risk to contract sanctity. Political risk insurers tend to use these ratings as an effective floor when pricing project-specific insurance packages. Since 2002, the ONDD has estimated expropriation risks independently of other types of political risk. Model (1) employs their seven-point scale from 2002 to 2008.

In model (2), investor expectations of the government's propensity to breach form the dependent variable. 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 the incidence of contract breach. I generate this dependent variable from the Political Risk Services International Country Risk Guide (ICRG), a set of indices to measure "potential risks to international business operations."<sup>10</sup> The ICRG data are based on analysis of the overall investment environment (without regard to nationality). I follow the scholarly literature in summing the values on four ICRG variables: *contract risks*; *FDI-related corruption*; *bureaucratic holdups*; and *law and order* (Allee and Peinhardt 2011; Li and Resnick 2003).<sup>11</sup> *Contract risks* includes expectations about risks to contract viability, profit repatriation, and timely payments. *FDI-related corruption* includes investor expectations about the willingness of government actors to carry out financial breach that includes demands for excess payments, exchange controls, and similar. It also includes expectations that host country actors use political power to deal unfairly with foreign investors, through actions like nepotism and job reservations. The sum of *contract risks* and *FDI-related corruption* captures a government's "tendency to adopt distributive policies and to make opportunistic use of public power" (Humphreys and Bates 2005, 412). I then add *bureaucratic holdups*, or the likelihood of discriminatory operational changes when governments

turn over. Finally, *law and order* captures judicial partiality and foreign firm-relevant crime. The resulting *breach expectations* have been highest in Africa and lowest in emerging Europe in most years, although there is much variation across regions and years.

Model (3) uses as the dependent variable the country risk rating from the Economist Intelligence Unit, available as of 2006. The rating “quantifies risks to business profitability” by aggregating across measures including financial risks, foreign trade and payments issues, government effectiveness, and the legal and regulatory environment.<sup>12</sup> Like model (2), this measure uses expert opinion on investor expectations about risks. Despite the noise that factors other than government behavior toward foreign property add to the measure, higher country risks should again be positively related to FDI national diversity.

## Estimation Strategy

I use multivariate regressions to estimate the effects of FDI national diversity, as specified in equation (2):

$$\text{Breach}_{it} = \beta_1 (\text{FDI national diversity})_{i, t-1} + \beta_2 \mathbf{X}_{i, t-1} + \gamma_i + \tau_t + \varepsilon_{ijt}. \quad (2)$$

The coefficient of interest is  $\beta_1$ , which measures the effect of change in *FDI national diversity* on breach of contract. It is hypothesized to be positive. The matrix  $\mathbf{X}_{i, t-1}$  contains a set of lagged time-varying controls. The next two terms are region/country and year fixed effects. Standard errors are robust and clustered by country to account for serial correlation (Zeger and Liang 1986). The panel covers 1990 through 2008 at maximum.

All models include both *FDI stock (logged)* and the running total of *BITs* to approximate the quantity of contracts the host government has made with MNCs and the access MNCs have to international arbitration (*World Development Indicators [WDI]*, The United Nations Conference on Trade and Development [UNCTAD]). I capture variation in the political determinants of FDI using *political constraints*, which accounts for the effects of institutions and policy stability on property rights violations and FDI flows (Henisz 2002).<sup>13</sup> The ideal control for the effect of the obsolescing bargain on a government’s propensity to breach would account for the FDI position in immobile industries by country-year. In the absence of robust international data, I use *natural resource exports* to control for fuel and mineral exports as a percentage of total merchandise exports, assuming that FDI in natural resources—as the most quintessential immobile industries—moves together with exports (World Trade Organization [WTO]). Gross domestic product (*GDP per capita, logged*) per capita (*logged*) captures development levels as well as variation in infrastructure investment, also prone to the obsolescing bargain (WDI). *GDP growth* accounts for the argument that economic downturn may make the short-term domestic benefits of breach more attractive to host governments (WDI). It also accounts for the contrary argument that governments have incentives to act

**Table 1.** FDI National Diversity and Likelihood of Government Breach of Contract.

	Model (1)	Model (2)	Model (3)
Dependent variable	Expropriation insurance price level	Breach expectations (ICRG)	Country risk score (EIU)
Scale	(1 = low, 7 = high)	(0 = low, 30 = high)	(0 = low, 100 = high)
FDI national diversity	0.061* (0.036)	0.267*** (0.099)	0.546* (0.330)
FDI stock (logged)	0.228 (0.272)	-0.960 (-1.028)	1.515 (1.468)
BITs, running total	-0.026 (0.016)	-0.012 (0.023)	0.020 (0.089)
Natural resource exports	-0.055 (0.054)	0.027 (0.157)	-0.771 (0.884)
Political constraints	-0.341 (0.299)	0.921 (0.968)	-4.195 (3.199)
GDP per capita (logged)	-1.017 (0.685)	-3.811** (1.592)	-4.925*** (1.477)
GDP growth	-0.015 (0.010)	-0.036 (0.026)	0.249 (0.258)
Constant	6.021 (6.952)	34.089 (28.496)	49.743 (32.773)
Observations	376	625	90
Number of countries	57	50	31
R <sup>2</sup> (within)	.28	.28	.16
Fixed effects	Country, year	Country, year	Region, year
Years covered	2002–2008	1990–2008	2006–2008

Note: BIT = Bilateral Investment Treaties; EIU = Economist Intelligence Unit; FDI = foreign direct investment; GDP = gross domestic product; ICRG = International Country Risk Guide. All independent variables lagged one year. Robust standard errors clustered by country.

\* $p < .1$ . \*\* $p < .05$ . \*\*\* $p < .01$ .

opportunistically when times are good and fairness in distribution becomes a more salient issue (Guriey, Kolotilin, and Sonin 2009).<sup>14</sup>

## Results

Models (1) through (3) in Table 1 show a consistently positive and significant association between a country's FDI national diversity and indicators of a government's propensity to break contracts. A one-standard deviation increase in FDI national diversity in model (1) is roughly similar to the increased contract risks in Venezuela from 2005—when the Chavez government was already engaging in nationalization—to 2007, by which time the government had expropriated firms from more national origins in more industries. In model (2), a one-standard deviation decrease is roughly similar to the change in contract risks in South Africa from 1993, when apartheid was outlawed only on the books, to 1995, after multiracial democratic elections had been held and the country was seen to have truly undertaken political economic reform. A rough real-world analogue to a one-standard deviation increase in FDI national diversity in model (3) is the period 2006 through 2008 in Slovakia, when the government threatened nationalization, as compared to Slovenia, a country that has been very discriminating in

allowing FDI and thus less prone to conflicts with existing investors. Controls for GDP per capita have some explanatory power.

The positive association between breach and FDI national diversity in the estimations contrasts with the insignificant associations between breach and *FDI stock*. Are there conditional effects? Ex ante, the direction of such an effect is unclear. A host country with more FDI stock may be less responsive to the constraints on breach brought about by FDI national diversity, feeling it has the cushion to breach even when FDI national diversity is low. On the other hand, a country with a low level of stock may feel it cannot compete and thus breaks contracts even when FDI national diversity is low (cf. Cai and Treisman 2005). Without a clear set of hypotheses, statistical analyses are unsurprisingly inconclusive.<sup>15</sup>

One concern might be reverse causality: if FDI national diversity has a direct effect on investment decisions, this would mean that investors incorporate FDI national diversity into their decisions, resulting in a direct effect on the incidence of breach. However, a causal story in which FDI national diversity 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 national diversity, thus lowering the mix in places with a high likelihood of government breach of contract (unless all national groups exit at an equal rate, in which case the mix would remain constant).

## Firm-level Evidence: More FDI National Diversity, More Government Arrears

A set of Enterprise Surveys conducted by the World Bank allow us to test Hypothesis 2 at the level of the firm. Executives at a variety of types of firms were asked the following question in 2003 or 2004: “What percent of your sales to government agencies or state-owned enterprises involve overdue payments?” Government arrears are a relatively common, clear form of breach in developing countries. Non-payment stands behind many public IAs, including the dozens of public IAs Argentina faced as a result of its 2002 default and surrounding financial crisis. I consider the presence or absence of reported arrears.<sup>16</sup> The theory suggests an interaction effect: FDI national diversity should have a significant and positive effect on the presence of arrears when firms are foreign. Data are available for 2,694 firms in twelve countries of which 12 percent are foreign. The logit model is as follows:

$$\Pr(\text{Arrears} = 1)_{ij} = \beta_1(\text{Foreign} \times \text{Diversity})_{ij} + \beta_2(\text{Foreign})_i + \beta_3(\text{Diversity})_j + \beta_5\mathbf{X}_i + \varepsilon_{ij}. \quad (3)$$

The first coefficient is the coefficient of interest. The next two terms account for direct effects of *foreignness* and *FDI national diversity*.  $\beta_5\mathbf{X}_i$  includes firm-level controls. Importantly, the World Bank Enterprise Surveys allow me to test the effects of FDI national diversity while accounting directly for firm industry. Firms report whether they are in *services*, *manufacturing*, *agroindustry*, or *construction*.

**Table 2.** FDI National Diversity and Government Arrears.

Dependent variable: Does firm report that sales to government agencies or state-owned enterprises involve overdue payments? Yes = 1, No = 0

	Model (4)	Model (5)	Model (6)
FDI National Diversity	-0.182* (0.098)	-0.181* (0.097)	-0.192** (0.097)
Foreign		0.322* (0.165)	0.030 (0.249)
FDI National Diversity × Foreign			0.128 (0.082)
Manufacturing <sup>a</sup>	-0.249 (0.517)	-0.235 (0.507)	-0.239 (0.507)
Agroindustry	-0.164 (0.600)	-0.159 (0.598)	-0.155 (0.597)
Construction	0.440** (0.215)	0.435** (0.215)	0.439** (0.215)
Exporter	-0.248 (0.207)	-0.303 (0.225)	-0.308 (0.225)
Africa <sup>b</sup>	0.337 (0.473)	0.308 (0.470)	0.325 (0.473)
Latin America	0.728** (0.366)	0.718** (0.366)	0.720** (0.364)
Asia	-1.075*** (0.395)	-1.106*** (0.392)	-1.107*** (0.392)
Emerging Europe	1.387** (0.548)	1.403*** (0.543)	1.400*** (0.543)
Constant	-0.944 (0.765)	-0.973 (0.751)	-0.945 (0.750)
Observations: 6,102			

Note: FDI = foreign direct investment. Surveys conducted in 2003 and 2004. Logit analysis. Robust SEs clustered by country.

<sup>a</sup>Omitted Category: Services.

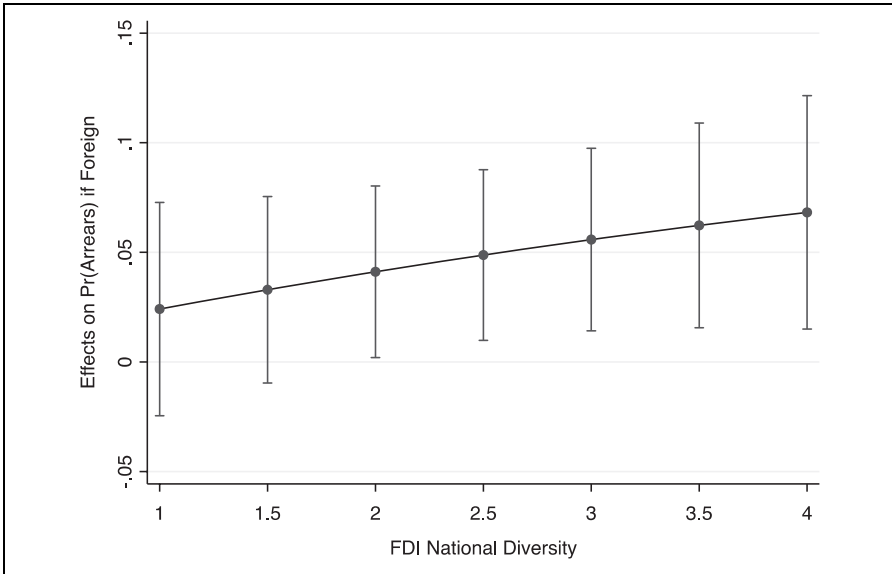
<sup>b</sup>Omitted Category: Middle East and North Africa.

\* $p < .1$ . \*\* $p < .05$ . \*\*\* $p < .01$ .

Relative to services, I expect construction firms—which, like natural resource firms, deal in immobile assets—to be more likely to face government arrears. Additionally, it is crucial to account for firm selection into the population of firms that could possibly be interviewed. If government nonpayment caused a firm to fail, those firms would nonsystematically drop out of the population and bias estimates in unpredictable ways. Thus, I control for whether a firm reports being an *exporter*, which can allow firms access to foreign exchange that may help them to survive despite government nonpayment. See Online Appendix Table 2 for summary statistics and Table 2A for available countries. Robust standard errors are clustered by country.

## Results

Table 2 reports regression results. In models (4) through (6), FDI national diversity has a significant and negative direct effect on the incidence of government arrears for both foreign and domestic firms. As predicted, firms involved in construction are significantly more likely to face arrears when compared to firms involved in services. Central to the hypothesis in question, the interaction term in model (7) is positive. Figure 3 displays the interaction effect graphically. If a firm is foreign, FDI national diversity starts to significantly increase the probability of facing arrears



**Figure 3.** Effect of FDI national diversity on government arrears if firm is foreign (model 6). Note. FDI = foreign direct investment.

when there are around two effective OECD nationalities present in the economy. While these data are limited to a small subset of countries, they provide another piece of evidence that when it comes to foreign firms, FDI national diversity can generate the space for government arrears and breach.

### Dyadic Tests: Conational FDI Drawdown

Independent investment decisions made inside each MNC are expected to aggregate to contribute to the positive relationship between FDI national diversity and breach in a country as a whole. Conational MNCs are likely to react to breach of contract in ways that constrain government access to capital, while MNCs of other nationalities are less likely to impose significant costs in terms of foregone capital. In this section, I use the incidence of public IA filings to demonstrate the different effects of breach on conational and other FDI flows.

### Public International IAs as Signals

Whatever the legal outcome of a particular public IA, filing alone is a sufficient indicator that the MNC involved perceives a breach of contract, as it is a costly action: the firm spends resources to bring a lawsuit (often after a mandated “cooling off” period); resolution usually 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.<sup>17</sup> In a public IA filing, foreign firms make their claims in the context of codified, international law, and the host government is committed enough to its contrary position to let the suit go forward in public, rather than settle out of court. This is a signal of the host government's resolve and attachment to a position contrary to an MNC's understanding of its property rights.<sup>18</sup>

In support of this rationale, Allee and Peinhardt (2011) find that host countries that have been sued in public IAs—regardless of outcome—receive fewer future FDI inflows. The hypothesis tested here goes a step further: FDI flows in a directed dyad should be lower following a conational public IA, whereas public IAs filed by investors of other nationalities should have no effect on FDI flows in a directed dyad.

## Estimation Strategy

I choose a within-dyad, over-time identification strategy. Equation (4) specifies the estimation model:

$$\begin{aligned} (\text{Net FDI inflow})_{i,j,t} = & \delta_1 \text{IA}_{i,j,t-1} + \delta_2 (\text{Other IA})_{j,t-1} + \beta_3 \mathbf{X}_{i,j,t-1} \\ & + \beta_1 \mathbf{X}_{j,t-1} + \beta_2 \mathbf{X}_{i,t-1} + \gamma_{i,j} + \tau_t + \varepsilon_{i,j,t}. \end{aligned} \quad (4)$$

The dependent variable is logged net FDI flows from advanced country  $i$  to host country  $j$  in year  $t$ . The third, fourth, and fifth terms of equation (4) are lagged time-varying dyad, host, and home 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. The panel covers 1998 through 2008.

The concept to be explained is variation in net FDI flows in the directed dyad between an advanced country and developing country, as I expect both current and potential conational investors to reconsider investments following evidence of nationality-tied risks to contract sanctity. Online Appendix Table 4A lists the sending countries included in the analysis. The table also notes the nineteen countries whose investors account for public IA filings in the data set. The analysis includes flows into 106 host countries around the developing world.<sup>19</sup> I follow the literature in adding a constant value to the dyadic FDI flows large enough to shift negative values to positive values; this allows me to log transform the data without losing observations that indicate net FDI divestment (Li and Vashchilko 2010).

The first independent variable of interest,  $\text{IA}_{i,j,t-1}$ , is a dummy of public IAs filed by firms from home country  $i$  against host country  $j$  in year  $t - 1$ .<sup>20</sup> The expectation is that firms from home country  $i$  are disproportionately responsible for FDI diversion in response to their own IAs; thus, the sign on  $\delta_1$  is hypothesized to be negative. The second independent variable of interest,  $(\text{Other IA})_{j,t-1}$ , is a dummy of public IAs brought by nationals of other home countries against host country  $j$  in year  $t - 1$ . IAs brought by firms that are not conationals are not expected to differentially affect FDI inflows in the



**Table 3.** Effects of Conational and Other IAs on FDI by Directed Dyad<sup>a</sup> (1998–2008).

	Model (7)	Model (8)	Model (9)	Model (10)
Conational IA (last year)		-0.003** (0.001)		
Other IA (last year)		-0.000 (0.000)		
Conational IA (last two years)			-0.003*** (0.001)	
Other IA (last two years)			0.000 (0.000)	
Conational IA (last five years)				
Other IA (last five years)				
Dyadic BIT in force	-0.002 (0.002)	-0.002 (0.002)	-0.003 (0.003)	-0.003* (0.002)
Dyadic trade (logged)	-0.000 (0.000)	-0.000 (0.000)	-0.000 (0.000)	0.001 (0.001)
Host political constraints	0.000 (0.001)	0.000 (0.001)	-0.000 (0.001)	-0.005 (0.005)
Host risks to property rights <sup>b</sup>	0.000* (0.000)	0.000* (0.000)	0.000 (0.000)	-0.000 (0.000)
Host country GDP per capita (logged)	0.004* (0.002)	0.004* (0.002)	0.003 (0.002)	0.005** (0.002)
Host country GDP growth	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Host country population (logged)	-0.026 (0.024)	-0.026 (0.024)	-0.032 (0.029)	-0.039 (0.038)
Host capital account openness	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
Home country GDP per capita (logged)	-0.011** (0.005)	-0.011** (0.005)	-0.011** (0.004)	-0.010** (0.005)
Home country GDP growth	0.000** (0.000)	0.000** (0.000)	0.000 (0.000)	0.000 (0.000)
Constant	18.731*** (0.447)	18.733*** (0.447)	18.832*** (0.516)	18.925*** (0.656)
Observations	11,960	11,960	11,070	8,447
Home–host dyads	2,512	2,512	2,491	2,410
R <sup>2</sup> (within)	.01	.01	.02	.02

Note: BIT = Bilateral Investment Treaties; FDI = foreign direct investment; GDP = gross domestic product; IAs = investment arbitrations Dyad and year fixed effects. All independent variables (except World FDI flows) lagged one year.

<sup>a</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>b</sup>This is the dependent variable used in Model (2) (International Country Risk Guide ICRG).

directed dyad; thus,  $\delta_2$  is hypothesized to be insignificant. In model (9), dummies indicate IAs filed in the previous two years; the dummies in model (10) indicate if IAs have been filed in the previous five years.

I account for several time-varying characteristics of the directed dyad, the host country, and the home country. The first key control is the presence of a *dyadic BIT in force* (UNCTAD).<sup>21</sup> Second, I control for *dyadic trade*, which scholars have long found to be associated with FDI flows.<sup>22</sup>

For the host country, I control as before for *political constraints* (Henisz 2002). Next, I control for *breach expectations* in the host country, which is also the dependent variable in model (2). MNCs have likely already factored such expected risks to property rights into their investment decisions, and public IAs are expected to send signals about additional information that allow firms to update their prior decisions. Following standard analyses of FDI flows, I also 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* (WDI; Chinn and Ito 2006). Additionally, macroeconomic trends in the home country likely have an effect on the willingness of firms of a given nationality to invest abroad. I therefore control for *home GDP per capita (logged)* and *home GDP growth* (WDI).<sup>23</sup>

## Results

Table 3 reports the regression results. Model (7) presents the basic specification without the IA variables of interest. In models (8) through (10), we see that conational IAs in previous years have a consistent and significant negative effect on future conational net FDI inflows. In each model, the filing of conational IA/IAs in the previous year or years decreases net dyadic FDI inflows by, on average, 0.3 percent. This long-term loss of dyadic FDI can generate real constraints over time in a foreign capital-reliant economy. In contrast, the filing of IAs 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 conational and other IAs are significantly different (with 95–99 percent confidence) and their covariance is 0, as implied by the theory.

The directionality of control variables provides support for the overall model specification.<sup>26</sup> Dyadic BITs have consistently positive though insignificant coefficients, throwing some support to the idea that it is not a BIT itself but the potential costs of a BIT—in the form of public IAs—that affect FDI flows. All else equal, countries with higher expectations of risks tend to get more FDI from the average sending country. This may reflect the many means firms have to deal with political risks *ex ante*, although the significant coefficients on conational IAs suggest that those preparations do not preclude future changes in investment behavior. 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.

Results of interest on conational and other IAs are robust to the use of the count of IAs as the explanatory variables, rather than indicator variables. Results are also

robust to replacing the incidence of a dyadic BIT with a running total of BITs in force in the host country, as Kerner (2009) and Buethé and Milner (2009) find that BITs have an effect on aggregate FDI regardless of with whom they are signed. Due to data constraints, including the incidence of Preferential Trade Treatments (PTAs) and dyadic Militarized Interstate Disputes (MIDS) as additional possible dyadic determinants of dyadic FDI markedly reduces sample sizes. PTAs are a significant predictor of dyadic FDI flows at 90 to 95 percent confidence levels, in line with expectations from a rich literature on PTA effects (Ghosn, Palmer, and Bremer 2004; Goldstein, Rivers, and Tomz 2007; Buethé and Milner 2008). Dyadic MIDS are not significant. When these variables are included, the signs on the coefficients of interest for conational IAs are negative as expected, though confidence varies from approximately 80 to 95 percent. Other IAs are, as before, insignificant. A one-, two-, or five-year change in the incidence of a public IA filed within a dyad has a negative effect on dyadic FDI flows, although the coefficient is significant at standard levels only in the two-year specification. Change in the incidence of other nationalities' IAs does not have significant effects in any differenced specification. Finally, in a placebo test in which flows are assigned to randomized (and thus incorrect) dyads, all IA variables are insignificant.

## Interpreting Dyadic Results

The dyadic results capture a specific chain of events. First, a breach of contract occurs with a given MNC. That MNC begins pulling down its investment or, indeed, loses its investment as a result of the breach. This should result in lower FDI from the home to the host prior to the filing of a public IA. Then, after a public IA is filed, other conationals in the host economy as well as potential conational investors receive a signal that makes them likely to draw down or divert FDI in response.

Take FDI from Germany into Thailand. In 1990, Thailand contracted with a German MNC to build a major new toll road, but in 1998 Thailand signed a contract with a Hong Kong firm to build a virtually identical road. The Thai government went on to refuse to allocate land for an exit ramp or to allow toll adjustments as spelled out in the German contract. Ultimately, the German MNC sold its shares and sued Thailand in 2005.<sup>25</sup> The analyses here suggest that decreased FDI flows after 2005 reflect, at least in part, other German firms' decisions to divert capital in response to the public IA. Indeed, the conflict was still prominent years later in 2011 when—as reported in *Der Spiegel*—the Thai prime minister worried that events surrounding the breach “should not be allowed to hurt bilateral ties.”<sup>26</sup>

## Conclusion

Arguments about nationality and economic globalization usually refer to the country that is host to FDI and the role its national borders play in a world of mobile capital, leaving MNCs aside as “meta-national.” In contrast, the findings here reestablish the importance of MNCs' homes. Far from having faded from relevance in a world

of economic globalization, MNCs' nationalities inform the sanctity of their contracts with host governments. In this way, MNCs fit Krasner's (1999) worldview in which national actors retain the trappings of sovereignty even in a globalized era.

One can think of nationality as a shield. Nationality can deflect threats to property rights because of the likelihood that an offending host government will lose conational capital following breach. If the shield is penetrated, the contract sanctity of not one but all conational firms is at stake. However, all else equal, when a contract is broken with a firm of one nationality, other nationalities' shields are likely to remain intact. Thus, 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.

A government's commitment to its own contracts is a key element of property rights protections, long thought integral to economic integration. Yet, deeper integration with a greater diversity of investor nationalities provides an opening for host governments to prioritize other goals over the property and preferences of foreign capital. Although it is a liability for MNCs, FDI national diversity is a boon for host government autonomy.

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### **Supplementary Material**

The online appendices are available at <http://jcr.sagepub.com/supplemental>.

### **Notes**

1. Developing countries include less developed, low-, and middle-income countries according to World Bank classifications. Firms can file suit under a Bilateral Investment Treaties (BIT) without their home government's approval, in contrast to the state-to-state dispute resolution process required at the World Trade Organization (WTO). As of 2012, the Energy Charter Treaty, North American Free Trade Agreement, and The United States-Dominican Republic-Central America Free Trade Agreement are the main multi-lateral instruments that have facilitated IAs.

2. Another set of costly actions by conational actors, in the form of diplomatic pressure, are discussed in Wellhausen (2013).
3. Most Favored Nation clauses in BITs cause some rights to spill over dyads.
4. Breach with investor groups of different sizes are not clear substitutes for each other. Governments have incentives to expropriate those with the biggest share (say, to supplement government revenues) and those with the smallest share (say, to carry out corruption).
5. Organisation for Economic Co-operation and Development (OECD) data, accessed February 2011. Following Fuentes and Saravia's (2010) use of the same OECD data, I leave missing values as missing. Negative foreign direct investment (FDI) stock is changed to zero, as this is the appropriate lower bound for measuring the presence of national investor groups.
6. The variable equals one in 7.6 percent of observations; these observations are dropped in analyses as indicative of missing data.
7. The distance between a country's most populated city and London is correlated  $-0.42$  with FDI national diversity (Mayer and Zignago 2011).
8. "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 (4th ed.).
9. International Monetary Fund (IMF) data on FDI country of origin. Unfortunately, worldwide data collection began only in 2009.
10. The PRS Group, "International Country Risk Guide Methodology." Available online at: <http://www.prsgroup.com/PDFS/icrgmethodology.pdf>.
11. Results are robust to constructing the combined measures with principal components estimation.
12. For methodology, see [eiu.com](http://eiu.com). Ratings are updated monthly; annual means are used here.
13. Results are robust to substituting democracy measures from Polity IV.
14. See Online Appendix Tables 1 and 1A for summary statistics and the maximum list of host countries included in the analysis.
15. Analyses including an interaction effect show the interaction to be insignificant. Results are available from the author.
16. The theory does not predict the level of arrears but rather their presence or absence; additionally, the distribution of responses is highly skewed.
17. Multinational corporations (MNCs) often have the right to file a public IA without exhausting local courts.
18. In the event that conational firms are sympathetic to the host government's position and do not take negative signals from a public IA filing, the effects of interest will be attenuated.
19. The data exclude observations where developed countries have been sued in IAs, which mainly occur between the United States and Canada under NAFTA Chapter 11. The theory implies that the fallout from these broken contracts is largely a bilateral affair, and firms of other nationalities should therefore remain uninvolved. Indeed, one does not see Mexican firms providing explicit support for American or Canadian firms in their public IAs.
20. Conationality is assigned based on the BIT under which an IA is registered. When *investment arbitrations* (IAs) are brought under a multilateral instrument, the country of residency of the claimant is used as the claimant's nationality.

21. If the parties have signed but not ratified a BIT, firms do not yet have the facility to file public IAs under that BIT.
22. Trade data are from the IMF Direction of Trade Statistics and the Correlates of War Project Trade Data Set (Barbieri, Keshk, and Pollins 2009).
23. See Online Appendix Table 3 for summary statistics.
24. The entry of new, major FDI projects make flows notoriously lumpy and difficult to predict. Model fits are in line with other work on the issue.
25. The German firm won an award of some EUR30 million in 2009. Narrative as reported in the resulting arbitration award. "Walter Bau AG (In Liquidation) Claimant and The Kingdom of Thailand Respondent." Award, July 1, 2009 (UNCITRAL, Germany–Thailand BIT).
26. Andreas Wassermann, "Thailand Pledges to Settle Dispute Over Prince's Jet." *Der Spiegel*, August 3, 2011.

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