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Economic Sanctions’ Effectiveness in a World with Interdependent Networks and Powerful MNCs: The Role of Governance in the Target State

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Abstract

Economic sanctions are increasingly becoming the instrument of choice for countries to exert pressure on others, due to their non-violent nature. However, sanctions effectiveness has often been a source of concern. There is a large body of literature analyzing what factors influence economic sanctions effectiveness, including political variables such as international cooperation, prior relations between sender and target states, etc., as well as economic variables such as the average cost of sanctions, trade linkages, etc. This thesis attempts to make a contribution by exploring the role of multinational corporations (MNCs) in sanctions regimes, as they have become the main actor in sanction implementation in the current globalized world. Given this context, there is a need to analyze the impact of sanctions on the profit maximization of firms, including the effect of the pressures applied by sender and target states to influence the implementation of sanctions by the MNCs. In exploring these issues, this thesis concludes that there is a factor that has generally been overlooked when analyzing the behavior of MNCs' responses to sanctions—the level of governance in the target state. The level of governance in the target state determines the environment in which MNCs operate. Furthermore, this influence over the strategic choice planning on firms will help determine the MNCs' decisions to either comply or evade the sanctions, eventually determining the level of sanctions effectiveness. This thesis has found both statistical and country case evidence in this regard, raising implications that could prove to be useful when designing and implementing economic sanctions in future cases.

Keywords

Economic Sanctions, Effectiveness, Governance, Political Science, Edward Mansfield, Mansfield, Edward

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SECTION 1: Introduction

In recent decades, global leaders have begun to rely more heavily on economic sanctions to exert pressure on other nations. These tools of economic statecraft have most often been implemented through a ban on economic activity such as trade, but can come in a variety of forms as evidenced by the use of sanctions in earlier civilizations. They originated as one of the many elements of war, starting with the siege of ancient cities, before evolving into more sophisticated forms of restrictions such as economic blockades in the 17th and 18th centuries in Europe. During the 20th century, sanctions as legal barriers to international trade embodied a new avenue for countries to exert pressure on one another without the use of force. This allowed countries to send strong signals to the opposing countries without incurring significant costs or losing citizen lives in combat. These tools gained popularity after the new international order began in 1945, when countries began perceiving the use of force as a last resort and thus became less inclined to use these means whenever conflicts between countries arose.

However, although sanctions hold several advantages over the use of force, they still hold many drawbacks that impede their effective use. They are difficult to manage and arduous to implement, thus calling into question their effectiveness. This is a critical issue that has received a great deal of attention. A vast literature has identified a number of political and economic variables that influence economic sanctions' effectiveness, including international cooperation, prior relations between sender and target states, the average cost of sanctions, trade linkages, etc. More recently, several studies have begun to focus on the role of market forces behind sanctions effectiveness. These studies noted that globalization has brought the actions of the multinational corporations (MNCs) to the forefront, as they are now the leading actors in sanctions implementation. The decision of MNCs regarding whether or not to comply or evade a sanctions regime could hold important implications for their effectiveness. Therefore, the conversation surrounding effectiveness has shifted from the actions of the state to those of the private sector.

This thesis seeks to contribute to the ongoing discussion of sanctions effectiveness, with a focus on the influence of governance in the target country on the decisions of MNCs regarding sanctions implementation. This is an important issue because as governments in sender countries exert pressure on MNCs to implement sanctions, governments in the target countries apply pressure on MNCs to prevent them from implementing these sanctions. Governance in the target country influences the balance between these pressures because it defines the environment in which MNCs operate, playing an important role in their profit maximization process. This process guides the strategic choice planning of firms, determining how sanctions are implemented and their eventual effectiveness. This study explores the role played by governance in the target state in influencing sanctions effectiveness through the lens of MNC activity. Furthermore, it reaches the conclusion that there is a positive relationship between the level of governance in the target country and sanctions effectiveness. This conclusion has important implications for the design and implementation of economic sanctions.

SECTION 2: Literature Review

Economic sanctions have become an increasingly important tool in economic statecraft in recent decades. These instruments for conflict-resolution allow countries to exert pressure on other countries through the use of economic penalties. Their popularity reflects the belief that sanctions are a low-cost alternative to war when diplomacy fails, especially when compared to the high costs associated with the use of military force. As the increasing wartime technology develops and weapons of mass destruction provide an existential threat, it is becoming increasingly common to defer to other methods of statecraft such as economic sanctions. However, the potential of economic sanctions is limited by questions surrounding their effectiveness.

While the definition of effectiveness may vary, a consensus seems to have emerged. As noted by Hufbauer, Schott, Elliott and Oegg ("Hufbauer") in *Economic Sanctions Reconsidered,* the effectiveness of sanctions has two parts: (i) "the extent to which the policy result sought by the sender country was …achieved" and (ii) the "contribution to success made by sanctions" (49). According to these measures, they "found sanctions to be at least partially successful in 24 percent of the cases documented" even though they depended heavily on "the type of policy or governmental change sought" (158). Many scholars have relied on this database as a key data source in analyzing the effectiveness of sanctions; however, the database has been criticized by some such as Robert A. Pape who question its accuracy. In *Why Economic Sanctions Do Not Work,* he disagrees with certain elements of the Hufbauer dataset, claiming that "an examination of the 40 cases in which Hufbauer claim economic sanctions were successful," only yielded "5 clear successes" (99). According to his analysis, the "remainder are accounted for by 4 classes of errors: 18 were determined by force, not economic sanctions; 8 are failures, in which the target state never concede to the coercer's demands; 6 are trade disputes, not instances of economic sanctions; and 3 are indeterminate" (101). Therefore, even though the "Hufbauer database has become the bedrock study on the effectiveness of economic sanctions," playing a key role "in significant U.S. foreign policy debates such as whether to rely on sanctions instead of use force against Iraq in 1991," it is important to keep in mind the limitations of these databases, as it is often difficult to delineate and properly track the influence of sanctions on the eventual concession of the target state.

Given this context, the question arises as to exactly what factors influence this variation in sanctions effectiveness. Hufbauer et al. identify political and economic variables behind sanctions' success or failure. On the political side, they look at factors including (i) companion policy measures, (ii) international cooperation, (iii) international assistance to the target country, (iv) prior relations between sender and target states, and (v) democracy vs. autocracy. On the economic side, they explore the effects of (i) the average cost of sanctions for the target state, (ii) country size, (iii) trade linkages, (iv) economic health, (v) political stability in the target country, and (vi) sanction type.

At the same time, as the world evolves from one of fragmented blocks to a globalized whole, the structure of international relations changes as well as the channels through which sanctions are implemented. This in turn requires a better understanding of the forces at play behind sanctions implementation, because it may lead to the emergence of new explanatory factors. In *Globalization: What's New? What's Not?*, Keohane and Nye refer to this phenomenon as "globalism" which involves "long-distance flows of goods, services, and capital, as well as the information and perception that accompany market exchange" (106). As the world emerged from World War II and worked together to build industrialism, "interdependence and globalism have become thicker, systemic relationships among different networks have become more important" and so there have been more "interconnections" (109). However, along with this change in transnational relationships with direct implications for the use of sanctions, comes a change in the most prominent actors in sanctions implementation.

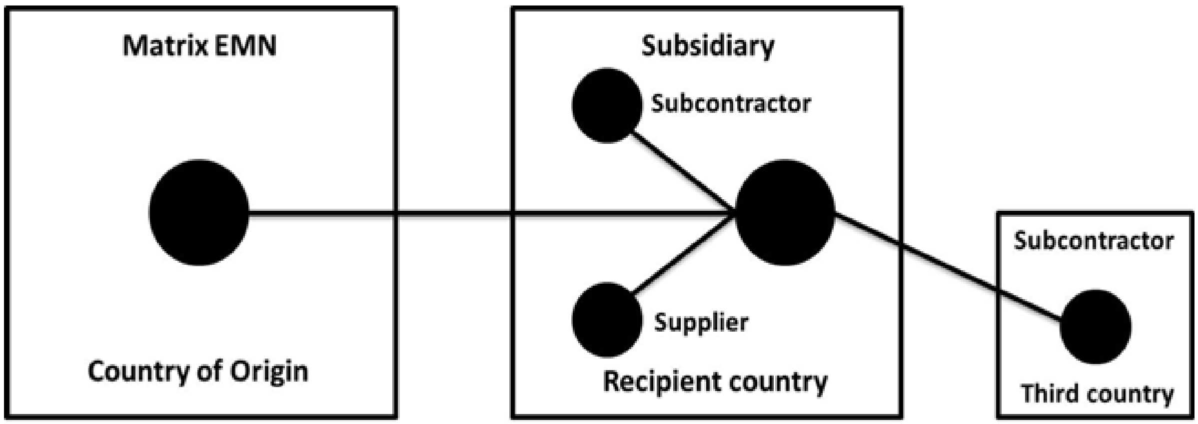
Much of the literature on sanctions stands on the presumption that sanctions are actions implemented directly by the government of the sender state. However, the evolving international economic environment with its increasingly interconnected and interdependent production networks has created a suitable environment for MNCs to become the lead actors in sanction implementation. As noted by Kenneth Rodman in *Sanctions Beyond Borders*, "multinational corporations, whose global spread and increasingly cosmopolitan outlook increased their independence from home governments," transformed from simple "instruments of foreign policy" to "autonomous actors whose self-interstate behavior could undercut strategies of economic statecraft" (4)… "weakening the impact of trade controls because these subsidiaries are wholly inside the jurisdiction of another country and out of the control of security planners" (4-5).

As the preconceived notion that the state is the leading actor in sanctions' implementation is slowly changing, there is a need to address the impact of the rise of these transnational actors. According to Clifton Morgan and Navin Bapat in *Imposing Sanctions: States, Firms, and Economic Coercion,* the sanctions literature "follows the argument that senders cut exchanges and impose costs on the target state" (65). They observe that "the exchange halted as a result of sanctions frequently does not occur between states" and instead occurs between "firms and the individuals of the sender and target state" which are forced to "absorb the cost of sanctions." Given that the interests of the sender state and the firm can often diverge as the former seeks maximum impact from the sanctions while the latter seeks profit maximization, the "domestic actors of the sender" often "attempt to illegally continue economic exchanges with the target" through various means of circumvention such as "moving their operations to countries that allow exchange with the target or using offshore locations." Morgan and Bapat explored these factors and developed a game theory model to help explain the different elements that go into the strategic choice planning of firms when deciding to comply or evade sanctions. They concluded that new factors such as (i) "the value a firm places on its economic exchange with a target state," (ii) "the probability a firm will come under investigation for sanctions violations," and (iii) "the level of the fine for sanctions violations," all come into play during the decision making process of MNCs. It is only when MNCs assess the level of risk associated with evading the sanctions, the possible costs incurred with getting caught, and the forgone profits, that they can make an informed decision on whether or not to comply with the sanctions and follow the demands of the sender state.

These studies show that the role played by governments in sender states has evolved from directly imposing export and import controls, to influencing MNCs to implement the sanctions, and for this they have to take into account how MNCs operate. David Rowe in *Manipulating the Market* analyzes the economic costs of trade sanctions (boycotts and embargos), showing the deadweight loss involved. He explains that as trade volumes shift as a result of the sanctions, there will be price changes that will cause market inefficiencies in the target state (see Appendix). In responding to these changes, MNCs with operations in the target state have different strategies. According to Rowe, the exporters' first strategy is to "persuade the target government to comply with the [sender state]'s… demands and cause sanctions to be lifted" in order to minimize the level of forgone profit caused by the sanctions regime (23). If this fails, they would attempt to "recover the windfall losses generated by sanctions" by pressuring the sender government, but their options in this regard are rather limited as it is unlikely that the sender government will fully compensate the firm for the forgone profits. Governments of sender states have a great deal of influence in this regard, because as stated by Rowe, "the government controls the state and thus holds a monopoly over the legitimate means of coercion," and "the government … [has]… the means and legal authority to monitor and coerce [exporters] … individual behavior" (24).

The actions available to the governments of the sender states to influence MNCs' behavior in order to maximize the impact of sanctions have received a great deal of attention in the literature. However, it is first important to consider how the structure of an MNC could lead to divergence in action between the headquarters and the subsidiaries based in different countries, under different jurisdictions. As shown in Figure 1, economic activity by the MNC will reside in multiple countries, depending on the presence of foreign subsidiaries or local contractors. MNCs can have their headquarters in the US, foreign subsidiaries in countries such as Japan, Germany, etc. and at the same time hold subcontractors in countries such as Bangladesh, in an effort to benefit from the cheaper labor and looser regulations.

Figure 1. Typical Structure of an MNC Today



Source: UNCTAD (1993). World Investment Report 1993, Transnational Corporations and Integrated International Production, New York, No. E.93.II.A.14 Graphic V.2, p. 119.

When deciding how to design sanction regimes, governments now have a variety of options to choose from, including trade and investment restrictions, asset freezes, travel bans, etc. with the option of either imposing comprehensive or targeted sanctions. Furthermore, governments in the sender state can also extend the legal jurisdiction of the MNCs headquartered in the sender state to the foreign subsidiaries located abroad through extraterritorial controls, meaning that the foreign subsidiaries located in the target countries would become liable for the sanctions as a result of these controls. As Rodman explains, these extraterritorial controls have often been used, as in the case of Rhodesia in 1965. At the time, the country "appl[ied] its embargoes and export controls extraterritorially to cover the foreign subsidiaries of US firms and US-origin technology and know-how even after they left the US boundaries" (23). These extraterritorial controls ensure that the sanctions hold a global reach, by making foreign subsidiaries liable for sanctions compliance. In the presence of these controls, the sender state can impose penalties on foreign subsidiaries that fail to comply with the sanctions, therefore making it more difficult for foreign subsidiaries to avoid sanctions compliance. The goal of these controls is to influence the cost-benefit analysis of these foreign subsidiaries, creating strong incentives for MNCs and their subsidiaries to comply with sanctions. Along with these controls, sender states are now aware of the tools that they have at their disposal through the use of sanctions, and there has been a great focus of the literature on the actions of the sender state.

However, there is less of an understanding of how these countries should tailor the sanctions to best fit the local considerations of the target state. There is a current gap in the literature that fails to explain how conditions in the target country influence the behavior of MNCs when deciding whether or not to comply with sanctions. Focusing on this gap could allow sender states to better utilize the various tools at their disposals when they enact economic sanctions, by seeking to exert the greatest impact on the strategic choice planning of firms. These targeted actions would influence the cost-benefit analysis of the MNCs and could eventually lead to their compliance of the sanctions, which is an integral element in determining the effectiveness of the sanctions regime as a whole. Therefore, sender states must not only consider the conditions of the target state, but also isolate certain key characteristics that will have the most influence on firm decisions. Given the ample variety of conditions in the target countries in terms of region, size, level of GDP, and many other indicators, the foreign subsidiaries of MNCs will inevitably react differently to the imposition of sanctions in different target states, as states are increasingly more likely to intervene in the activity of foreign subsidiaries located in their country. According to the Yves Doz and C.K. Prahalad in *How MNCs Cope with Host*

Government Intervention, in "recent years, the efforts of host governments to maintain control over their own national economies have increasingly restricted the freedom of MNC managers in deploying economic resources" as well as "have often interfered with the autonomous process of strategy formation" (414). These limitations to strategic freedom have "primarily affected multinationals in the form of such locally sensitive issues as product/market choice, use of technology, level of employment, and national trade balance." Therefore, the power that the target states use as conditions for the foreign subsidiary to be located in their country can heavily influence the MNCs' cost-benefit analysis, affecting the way they attempt to maximize profits.

However, in linking how conditions in the target state influence sanctions effectiveness, the current studies in the literature generally fail to explore the dynamic between the target state and MNCs' activity, disregarding its importance. One exception is a study by Risa Brooks in *Sanctions and Regime Types, What Works and When*, which looks at the relationship between government regime type in the target country and the effectiveness of sanctions. In the article, Brooks concludes that sanctions are more effective when the target country is democratic rather than authoritarian. This conclusion is based only on political considerations, namely that the leaders in democratic countries are more vulnerable to the complaints of those affected by the sanctions. As public opinion plays an important role in maintaining those in power, the suffering of the leaders' constituents as a result of the sanctions will likely have more teeth, influencing leaders to concede to demands more easily. This is not necessarily the case in autocratic regimes, where the leadership lacks a degree of accountability to the constituents and does not feel the need to rectify the situation in order to maintain their hold on power.

Furthermore, due to the government's strong influence over the media, they are more easily able to hide the suffering of their people from other nations that could have otherwise put pressure on the government. Therefore, Brooks suggests that in an effort to make sanctions more effective, the nature of the sanctions should be tailored to the specific considerations of each target state involved. For example, if dealing with an autocratic regime with low levels of governance, it would be a more reasonable approach to enact specific, targeted sanctions in the form of travel bans, asset freezes, etc. directed at the top leaders in the state and not necessarily enact them on the entire population. On the other hand, when dealing with a more democratic form of government where the population could heavily influence leadership through their voting power, comprehensive sanctions would be more likely to hold and lead to concessions from the target state. Therefore, Brooks proposes to design an effective sanctions regime based on not only the goals of the sender state but also on the regime type of the target state.

Another important work that focuses on conditions in the target state is the seminal study of Hufbauer. In particular, they focused on economic health and political stability of the target state and found that these "variables are mixed and weaker than expected, and (they) believe that this area would benefit from further research" (99). Although these studies have drawn attention to the conditions in the target state as determinants of sanctions effectiveness, their approach is macro and traditional, failing to explore how conditions in the target state affect the new channels through which sanctions are implemented. Given the rising prominence of the actions of the MNCs in determining sanctions success, it is important to properly analyze how MNCs will change their reactions to economic sanctions due to the environment they face in the target state.

This is an important gap in the literature, because in a globalized world, MNCs are the ones that implement sanctions, and sanctions effectiveness will depend to a large extent on the factors that guide MNC actions and their reactions to the imposition of sanctions. This paper attempts to make a contribution toward closing this gap by exploring how conditions in the target country, namely governance, influence sanctions effectiveness through the way they affect how MNCs implement sanctions.

SECTION 3: Research Question and Hypothesis

When analyzing the conditions in the target country that influence the profit-maximizing decisions of MNCs, the literature has already analyzed the impact of a number of variables, as discussed above. However, there are other factors that have not yet been explored in the literature. In this context, this thesis will discuss sanctions effectiveness by focusing on the reaction of MNCs. As MNC behavior is guided by profit maximization, bringing into the discussion the environment in which these MNCs operate in the target country is of critical importance. One of the most important factors that determine this environment is governance.

In the "Worldwide Governance Indicators," the World Bank defines governance as "consist[ing] of the traditions and institutions by which authority in a country is exercised. This includes the "process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them." More specifically, this idea of governance can be presented into quantifiable measures that include "voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption." As such, governance reflects the quality of the legal system in the country, including the scope, reach, modernity, stability, and simplicity of the laws, the respect for the rule of law, and the quality of the judiciary system. Furthermore, governance also encompasses the quality of the regulatory system, the absence of corruption, and the quality of the institutions in the country. Consisting with this definition, the United Nations stated "good governance assures that corruption is minimized, the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making." This definition makes clear that governance in the target state helps determines to a large extent the environment in which MNCs operate when applying sanctions, and raises the possibility that governance plays a large role in explaining how MNCs react to the given stimulus associated with the imposition of sanctions.

Thus, the research question of this thesis is as follows: In a world with interdependent production networks and powerful MNCs, how do the characteristics of the target state, in particular its level of governance, influence MNCs to either comply or evade economic sanctions, leading to a causal relationship between governance and sanctions effectiveness?

To answer this question, this study focuses on MNC behavior, as MNCs operating in the target countries are the ones that implement sanctions in a globalized world. Their actions following the imposition of sanctions are the critical drivers of the final effectiveness of sanctions. MNCs are guided by profit maximization, which in turn is heavily influenced by the environment in which they operate in the target state. Among the factors that determine this environment in the target state, the governance level will be crucial as it defines the rules of the game for the MNCs as they implement sanctions. Therefore, there are valid reasons to expect that a relationship exists between governance in the target state and sanctions effectiveness.

To analyze the relationship between governance in the target state and sanctions effectiveness, this note relies on a three-pronged approach, including: (i) a logical analysis, (ii) a quantitative testing of the hypotheses, and (iii) specific country cases.

SECTION 4: Logical Analysis

This section discusses the link between the level of governance in the target country and sanctions effectiveness from an analytical point of view, by dissecting how sanctions are implemented by MNCs.

As presented in equation (1) below, there are many factors that explain sanctions effectiveness (E), such as the size of the sender country (a), size of the target country (b), trade linkages (c), types of sanctions (d), political stability in the target state (e), etc. These factors have been analyzed in detail by many scholars such as Hufbauer et.al, but this thesis proposes an additional variable that could be playing an important role in determining sanctions effectiveness: the governance in the target country (G).

$$\boxed{(1) \qquad \mathbf{E= f\ (a, b, c, d, e\ldots,G)}}$$

To understand why governance plays a role in determining sanctions effectiveness, it is important to start with the fact that sanctions are intrinsically linked to international trade, which is largely dominated by the actions of MNCs. Since MNCs often act as the main players in the implementation of sanctions, the variables that influence their behavior will be key for explaining sanctions effectiveness.

Since MNCs are profit-maximizing entities, their strategic choices depend on the net impact of these sanctions on their profits. Sanctions adversely affect the profits of the MNCs because the loss of a trading partner decreed by the sanctions is equivalent to the imposition of a production quota on the MNC, which limits its production to a level below its profit maximizing equilibrium. As a result, profits fall because with a price determined at international markets, the MNC cannot raise its prices to compensate for the loss in quantity sold. The MNC could try to allocate its idle capacity to produce for alternative markets; however this substitution is not always possible as it is difficult and costly to gain access to new markets. Under these circumstances, the MNCs have an incentive not to comply with the sanctions in order to maintain their previous level of profits (the profit maximizing level), by continuing to produce or sell its production in the sanctioned country. The government of the sender country is aware of this, and pressures the MNC to comply with the sanctions through the threat of penalties for noncompliance. In their cost-benefit analysis, the MNCs need to consider these additional costs imposed on the firm for evading the sanctions, which could move the needle in the direction of complying with them. However, target states are also aware of this dynamic, and they would therefore attempt to counter the actions of the sender country by threatening penalties on the MNCs for complying with the sanctions. The effect of these two opposing forces and the way they interact contribute to the way MNCs implement sanctions, and ultimately to sanctions' effectiveness.

The discussion above can be summarized in a simple equation that represents the net costs faced by MNCs after the imposition of a sanctions regime:

$$\boxed{(2)\ \mathbf{NC = FP + S + T}}$$

where:

NC are the net costs a sanctions regime for the MNCs,

FP are the profits forgone for implementing sanctions, because sanctions force the MNCs to produce less than the level associated with the maximization of profits,

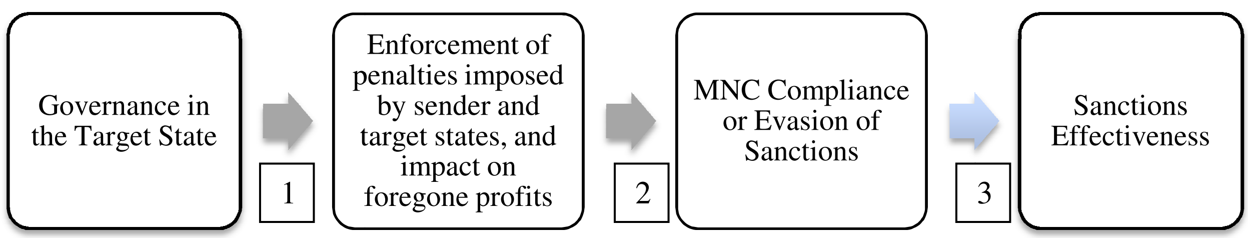
S are the cost of penalties imposed by the sender state on firms for not implementing the sanctions, as the sender state seeks to force MNCs to implement these sanctions, and

T are the cost of penalties imposed by the target state on firms for implementing the sanctions as it seeks to force MNCs not to implement sanctions imposed on the country.

MNCs fully implementing sanctions forego FP profits and pay T penalties to the target state; hence the cost they face is FP + T. If sanctions are not implemented at all by the MNC, it does not forego any profits (FP=0), but has to pay the penalty imposed by the sender state, S. Based on this equation, the target state would try to influence the actions of the MNCs by increasing T (or reducing the value of S if it can) so as to make sure that FP+T is always higher than S, thus providing an incentive for the MNC not to implement sanctions. Partial compliance with sanctions would result in MNCs paying some penalties to the target state (T), as well as to the sender state (S), and foregoing some profits (FP).

The crucial issue to keep in mind at this stage of the analysis is that while governments impose notional penalties, the actual penalty paid by the MNCs will depend on the enforcement of that penalty. Only if governments have an accurate assessment of whether sanctions are being implemented or not, will they be able to enforce a penalty on the MNC. Hence, the ability of governments to enforce these penalties depends on their ability to monitor sanctions implementation. This in turn is heavily influenced by the level of governance in the target state, which affects the governments' ability to enforce penalties in a manner that is consistent with the actual implementation of sanctions. These elements are key in the strategic planning of the firms, as they assess the actual cost they face from a sanctions regime, as they go about deciding how much of the sanctions to implement. It is at this level that governance in the target state becomes a major determinant of the strategic choices made by MNCs.

When deciding how to implement sanctions, MNCs seek to minimize the net costs from sanctions depicted in equation (2). Based on these considerations, this study explores how the MNCs try to minimize these costs, and provides a logical framework showing the underpinnings of the direct relationship between governance in the target state and sanctions effectiveness, as shown below.



<u>Link 1</u>: The relationship between governance and (i) the enforcement of penalties and (ii) the level of foregone profit is a critical link in the causal mechanism connecting governance and sanctions effectiveness.

a) <u>Impact of governance in the target state on the actual value of penalties imposed by the sender state (S)</u>: The environment in the target state where the MNCs implement sanctions is key in the ability of sender countries to enforce the penalties they have announced (S). This environment is determined to a large extent by the level of governance. The level of corruption, the existence of informal markets, the strength of institutions and the level of transparency in the target state affect the ability of the sender country to monitor how the MNCs are implementing sanctions. When governance in the target state is strong (low corruption, no informal markets, strong institutions, high transparency, etc.), MNCs operate in a market with free flow of information, which makes it easier for the sender state to assess how sanctions are implemented and what are the foregone profits associated with them. However, when the level of governance in the target country is weak, with high corruption, prevalence of informal markets, weak institutions, poor transparency, etc., MNCs have many avenues to evade sanctions undetected from the sender state. The lack of knowledge held by the sender state about the actual implementation of sanctions by the MNCs reduces the actual value of the net cost that the MNCs face as a result of the sanctions regime. Under these circumstances, the sender government cannot apply a level of S that accurately matches the evasion of sanctions, and the actual value of S faced by the MNCs differs significantly from the theoretical values intended by the governments. If sanctions evasion is undetected, the actual value of S is significantly below what the sender government intended, and weak governance in the target state makes this possible. In sum, the status of governance in the target state determines to a large extent the real cost for the MNCs of implementing or evading sanctions, as depicted in equation (2). This is the first and more critical link in the chain that relates governance and the effectiveness of sanctions. Without strong monitoring of penalties by the sender state, the enforcement of sanctions is severely compromised, affecting the implementation by MNCs.

b) Impact of governance in the target state on the actual value of the penalties imposed by the target state (T): Governance in the target state also affects the target country's ability to monitor how the MNCs are applying sanctions, thus affecting their ability to enforce their own penalties T on MNCs for complying with sanctions. When governance in the target state is weak, the capacity to monitor the actions by MNCs is also low in theory. Hence, the enforcement of the penalties by the target state (T) would also be weak. This raises the possibility that MNCs could implement sanctions without incurring the penalties from the target state. However, if target governance is weak, target states can resort to other informal channels to ensure that MNCs do not apply sanctions, for instance by applying the theoretical level of T penalty regardless of what they know about actual sanction implementation. This would occur because in a target state with low levels of governance, there is no institution from where to seek protection against government actions. On the other hand, when governance in the target state is strong, then the sender state will have the ability to monitor sanctions implementation and would be in a better position to enforce penalties S that are accurately linked to this implementation level. The target state also has the ability to monitor what the MNCs are doing and can apply penalties that are better linked to the implementation of sanctions as well.

c) Impact of governance in target state on the actual value of foregone profits (FP): Governance is a major determinant of the environment where the MNCs operate, and it determines to a large extent their ability to generate profits. As discussed by Paolo Mauro in *Corruption and Growth*, respect for the law, strong and predictable regulatory environment, absence of corruption and strong institutions, allow MNCs to operate with flexibility and long-term horizons. On the other hand, weak institutions disrespect for the law and pervasive corruption foster economic waste and inefficiencies that hinder firm's profits. As governance impacts the level of profits that can be achieved in the economy, it also affects the potential foregone profits from a sanctions regime (higher levels of governance implies higher foregone profits from sanctions and vice versa). However, this impact is offset by the fact that governments in countries with weak governance could help subsidiaries of MNCs avoid the impact of foregone profits (e.g., through smuggling, sanctions busters or bribes). This would allow them to create new avenues for the MNCs to reach their previous levels of profits, and reduce the level of FP. Therefore, by helping MNCs to evade sanctions undetected, weak governance also minimizes the value of foregone profits.

Link 2: The discussion above makes it clear that the level of governance in the target state affects the balance of costs imposed by governments as they try to influence the MNCs in implementing sanctions as well as the foregone profits. As presented in the equation (2), the balance of net costs faced by MNCs following the imposition of sanctions will depend on the actual enforcement of penalties T and S and on the level of foregone profits FP. As discussed above, the actual values of FP, T, and S are heavily influenced by the conditions of governance in the target state, thus the governance level also affects the final balance between these factors. The strategic decision of the MNCs of how much to implement sanctions will be determined by the relative weight of the actual enforcement of S and T, as well as by FP. As equation (2) outlines, MNCs will have a greater incentive to implement sanctions if the cost imposed by the sender state for not implementing sanctions (S) is high and exceeds the sum of foregone profits (FP), and the cost of penalties imposed by the target state for implementing the sanctions (T). This would mean that the MNC would rather comply with the sanctions in order to avoid having to incur the costs of the penalties for failing to comply with the sanctions, as they outweigh the forgone profit levels.

Link 3: The strategic decisions of the MNCs regarding the implementation of sanctions will largely determine the effectiveness of the sanctions regime. This is due to their role as the main actor behind sanctions implementation, as previously explained.

In conclusion, MNCs operating in target countries with strong governance are likely to implement sanctions in a manner that is different from the implementation of sanctions by MNCs operating in countries where governance is weak, because they would be facing different net actual costs for implementing the sanctions. Thus, there is a logical reason to conclude that a relationship does exist between governance and sanction effectiveness, which can be further explained by MNC activity in the target state.

The question then becomes what kind of influence does governance in the target state have on the ability of target and sender states to influence the decisions of the MNCs regarding the implementation of sanctions? The answer to this question relies on the assumption that stronger governance in the target state leaves MNCs more vulnerable to the reach of the sender state. In countries with stronger governance, information flows more easily and is readily available for not only the sender state but also for the international community as well. Moreover, there is no corruption to facilitate back channels to evade sanctions unnoticed, and the target state does not have unbounded powers to coerce the MNCs to evade sanctions unlike countries with low governance where a direct link between governments and MNCs is more likely. This allows for the creation of a hypothesis regarding the original research question. Contrary to what may seem at first intuitive, stronger governance in the target country tends to make MNCs less vulnerable to the target state and more vulnerable to the sender state. Therefore, strong governance in the target country would tend to be associated with more effective sanctions, implying that the relationship is positive.

The same conclusion is reached when governance in the target country is weak. In this case, this would mean that the MNC was influenced by the government of the target state to evade the sanctions. This requires S to be lower than the sum of FP and T. In this scenario, due to the weak governance in the target country, the sender state's government finds it very difficult to apply penalties on MNCs for not complying with the sanctions. Information does not flow as well in these cases and there is corruption that allows countries to evade sanctions unnoticed, both factors reducing S, while the MNCs in this case are less protected from the actions of the target government because institutions are weak. Therefore, this would allow for greater levels of T and lower levels of S, making the cost of complying (FP + T) higher than the cost of not complying (S). The result is that sanctions would not be as effective in target countries where governance is weak. Again, the relationship between governance and sanction effectiveness is positive.

This analytical discussion provides logical support for the existence of a positive link between governance in the target country and sanctions effectiveness through the profit maximizing operations of MNCs. However, it must be supported through a statistical analysis as well as country case studies.

SECTION 5: Statistical Analysis

The second leg of the research is a statistical test of the link between governance in the target state and sanctions effectiveness. This is a very preliminary test, subject to many weaknesses, mainly due to the lack of formal theoretical model of MNCs profit-maximizing behavior linking governance in the target state and sanctions effectiveness. The design of such a full-fledged model and statistical analysis is an undertaking that is beyond the scope of this paper. Moreover, while some data for sanctions effectiveness is available in Hufbauer et al., it is not nearly as well developed as it is needed for conducting the advanced econometrics tests that would be required, such as a more sophisticated logit analysis which was first tried by Long and Freese. These authors used "logit modes… to estimate the likelihood of successful outcome [for sanctions] based on the values of the independent variables." As recognized by Hufbauer et al, the use of these techniques to predict the success or failure of economic sanctions "still lies beyond the grasp…of modern econometric methods."

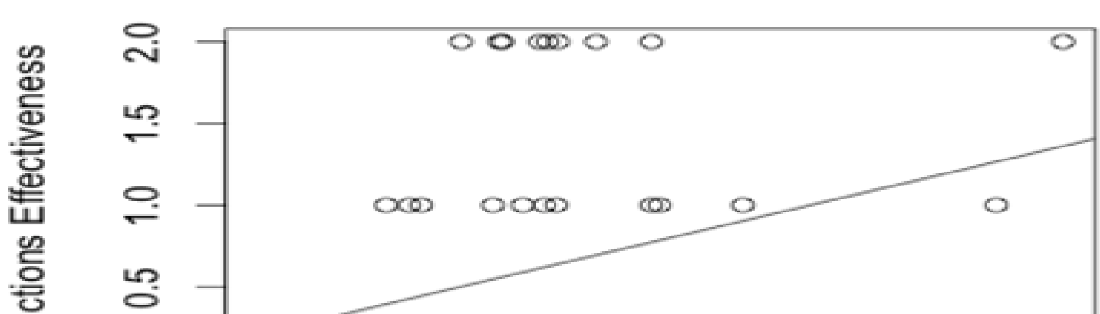
Instead, this paper follows the guidance provided by Hufbauer et al and conducts a weak test of the link between governance and sanction effectiveness, with the view to "find[ing] some basis for the power of key individual variables to explain the effectiveness of sanctions."

When structuring the regression, the following variables were considered:

Dependent variable: Sanctions' effectiveness, as defined by an index calculated by Hufbauer et al, which ranges from 0 to 16. However, this index only captures the sanctions episodes up until 2000. For the more recent sanctions episodes, Hufbauer included a more qualitative account of the success, categorizing the sanctions as successful, unsuccessful, or inconclusive. In order to include these sanctions regimes into the data, the most recent sanctions were classified as 0, 1, or 2 according to the level of success. Then, this information was comingled with the Hufbauer dataset, and sanctions with scores 0-6 in Hufbauer et al. were given a 0 (ineffective), scores 7-9 were given a 1 (inconclusive), and scores 10-16 were given a 2 (effective).

Independent variable: Governance, as measured by the Worldwide Governance Indicators (WGI) developed by the World Bank for 215 countries. The regression was also run against two of the sub-components or dimensions of governance that are key determinants of MNC behavior. Out of the dimensions including: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and freedom from corruption, for the purpose of this thesis, the dimensions that are analyzed are regulatory quality and freedom from corruption. Each independent variable was assessed against the level of effectiveness as outlined in the 0, 1, 2 scale with the following results.

Figure 2. Sanctions Effectiveness vs. Governance in Target State



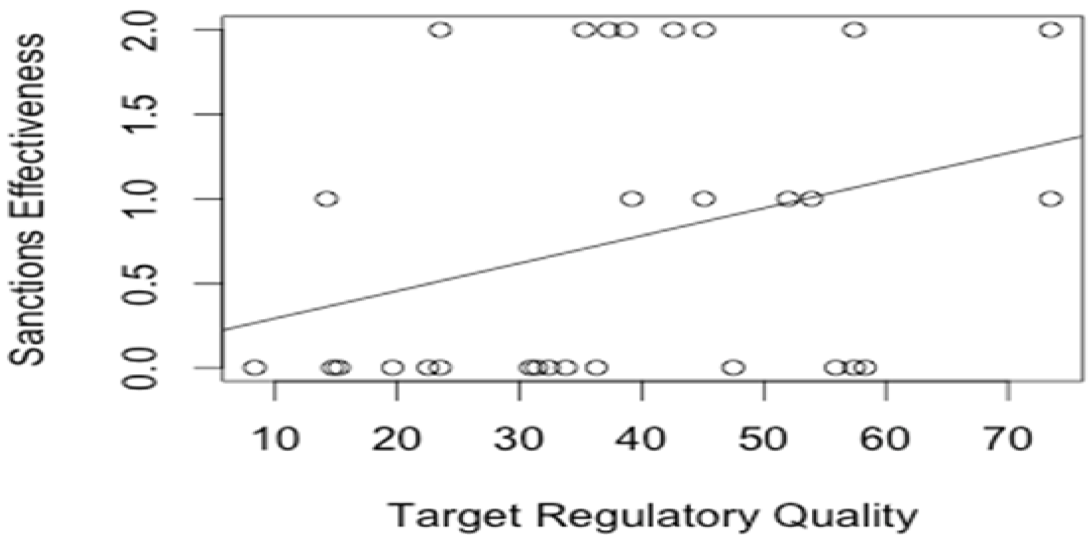
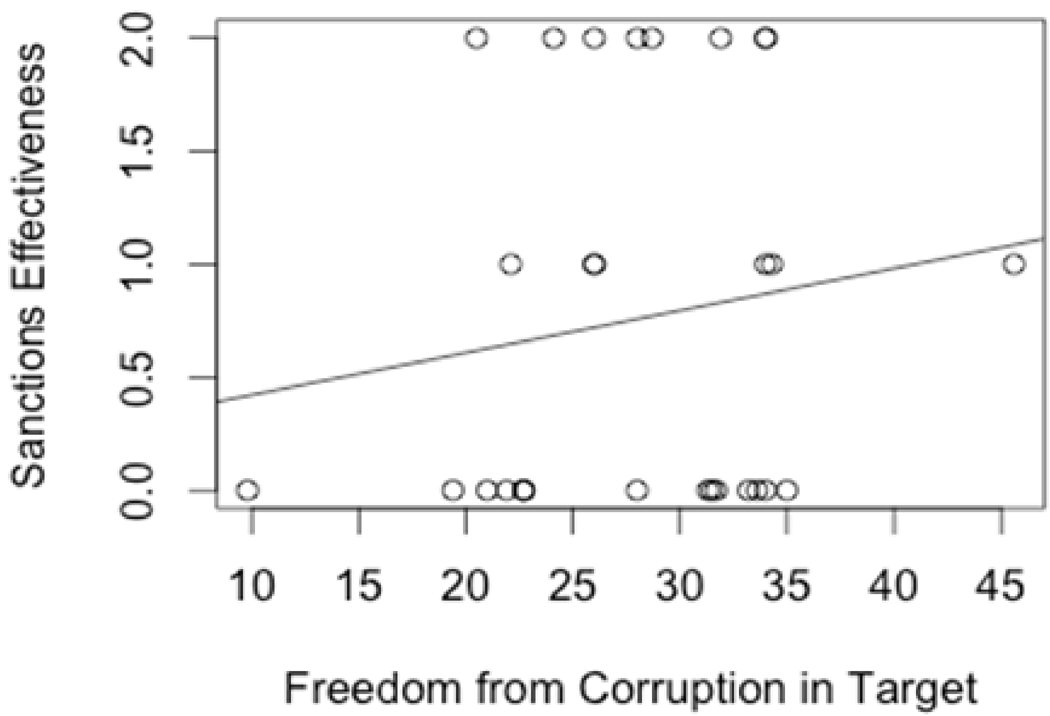


Figure 4. Sanctions Effectiveness vs. Freedom from Corruption in Target State



As shown in the graphs above, the Ordinary Least Square (OLS) model does not work properly for this data, as the dependent variable is not normally distributed. Therefore, this test uses a univariate logit regression, with governance in the target state and two of its sub-components (regulatory quality and freedom from corruption) as further explanatory variables for sanctions effectiveness. This type of regression could properly account for the categorical dependent variables that correct for the lack of a normal distribution in the dependent variables.

The regression results are described below, using the generalized linear models (glm) function that provides the ordinal logit function:

	Estimate	*Std. Error*	*t value*	*Pr (>|t|)*

Intercept	*0.155244*	*0.2072164*	*0.749*	*0.457*
Governance	*0.0023825*	*0.0009986*	*2.386*	***0.021***

According to the regression, the relationship between governance and sanctions effectiveness is small and positive, as indicated by the Beta of 0.002385. Since it has a p value of 0.021, a statistically significant result at the 5% level, this indicates that the relationship is not due to statistical errors alone. It is interesting to note that the regression on the level of governance of the target state vis-à-vis the effectiveness of the sanctions shows a statistically significant result. The sign provides some statistical support, though weak, for the thesis that there is a positive linkage between governance and sanctions effectiveness.

There are many different ways to try to strengthen the results, especially by adding other variables to the regression, but none of those attempted produced results that were significantly stronger than the one presented above. A reason for this could be that governance is related to the other explanatory variables, generating a multicollinearity problem. While there are ways to test for the existence of this problem, no comprehensive test was conducted. This is the case because while there were some preliminary indications of a relationship between governance and these other explanatory variables, the causality between them could not be properly identified. Under these circumstances, it was decided to limit the statistical analysis to the result presented above.

In sum, the statistical analysis supports the hypothesis that a positive relationship exists between governance in the target state and sanctions effectiveness, although it must be acknowledged that the conclusion is relatively weak from a statistical point of view. In any case, while not conclusive, these results allow for the possibility that a positive relationship does exist between governance in the target state and sanction effectiveness.

SECTION 6: Case Studies

The third leg of the study focuses on two country cases of sanctions with varying degrees of governance in the target state. The analysis focuses on how the particular characteristics of governance in the target states affected the profit maximization of MNCs and led them to implement sanctions in a manner consistent with the hypothesis of this thesis, i.e., confirming or refuting that governance and sanctions effectiveness are positively related.

The cases to be analyzed are (1) the sanctions imposed by the US on South Africa in 1986 and (2) the sanctions imposed by the US on Iran in 1995.

Methodology: For each country case, this section analyzes how the MNCs reacted to sanctions in the context of the governance in the target states. The analysis starts by providing background information of the target country before sanctions were introduced, including a description of the political and economic situation at the time, the government regime in place and the status of governance in the country. The following sub-sections focus on the nature of the sanctions that were enacted and the way the MNCs responded to them. The analysis follows the lines of the arguments provided in the analytical section above and the equation (2) to test whether they are supported or not in these specific cases. In particular, the theoretical arguments linking governance in the target country and the three variables (FP, S, and T) that determine how MNCs react to the sanctions are analyzed to find whether there is evidence to confirm the positive link between governance and sanctions effectiveness as shown by the statistical analysis.

When considering these arguments and applying them to the relevant case studies, particularly emphasis is placed on how the relationship between governance and sanction effectiveness is affected by a number of variables, including in particular (i) the level of private sector independence, (ii) the role of market forces, (iii) the strength of the penalties enacted by the sender state, (iv) the strength of the penalties enacted by the target state, and (v) the impact of governance on foregone profits in implementing sanctions. Each case concludes with comments on the (vi) relative MNC compliance levels and effectiveness of the sanctions regime.

South Africa

This case explores the sanctions imposed by the United States on South Africa in 1985-1986 during the apartheid regime, which is an interesting example of sanctions applied to a target country with a relatively strong level of governance. This case is characterized by (i) a high level of private sector independence, (ii) high prevalence of market forces, (iii) strong penalties for evasion of the sanctions enacted by the sender state on the MNCs, (iv) low impact of the penalties for compliance of sanctions enacted by the target state, (v) level of foregone profits not sufficient to force MNCs to comply with the sanctions, (vi) a high level of MNC compliance and eventual effectiveness of the sanctions

Background Information

South Africa is a country located in the southern tip of the African continent. A former British colony, South Africa is the 25th largest country in the world, both in terms of land and population, which exceeds 50 million people, 80 percent of which are of black origin. Its GDP at the time of the sanctions was around US$ 300 billion, ranking 90th in the world, reflecting the poverty and disenfranchisement that affected its black population as a result of the apartheid regime. This regime was introduced in 1948 and institutionalized racial segregation, granting most political and economic power to the white minority. This not only kept the black population suppressed and struggling with poverty, but also institutionalized the marginalization of this segment of society.

Governance Level

When assessing the case of South Africa, it is first important to outline the level of governance during apartheid, which according to the Worldwide Governance Indicators, was relatively high compared to most other target states. Although this may seem counterintuitive given the absence of certain liberties and rights as dictated by apartheid, the assessment of the degree of governance in this case is stripped of ideology and instead focuses on the structure of the governance at hand. In fact, there is a consensus in the literature that governance level for South Africa at the time of apartheid was relatively strong compared to other target states subject to sanctions. Furthermore, South Africa not only ranked relatively high in terms of the overall level of governance, but also ranked high in the two key elements that are especially relevant for MNC activity—freedom from corruption and respect for the rule of law. South Africa maintained low levels of corruption and a strong regulatory framework. The consensus in the literature points to this characterization as well.

According to *After Apartheid* by Ian Shapiro and Kahreen Tebeau, if one "ignored the ideology and focused on the formal feature of apartheid legal order, …[South Africa] replicated the constitutional structure of the British legal order" (234). When assessing governance with respect to the institutions present within society and the rule of law, South Africa had the same characteristics as Great Britain during the apartheid regime. As Shapiro and Tebeau explain, the "politicians from the political party with the majority of seats formed the government and governed only as long as….they enjoyed the confidence of the majority of parliamentarians" (234). Furthermore, the assessment of the relative rule of law present in South Africa does not focus on whether or not the laws set by the government were deemed as morally acceptable or not, but instead on whether the principle of legality was followed. In South Africa, an "independent judiciary had the task of interpreting the law and so could determine when government officials were acting within the scope of the authority delegated by the legislature, but did not have the authority to invalidate statutes" (234). Furthermore, not only did the "apartheid legal order acknowledge the supremacy of the constitution, but the virtue of the kind of constitution it acknowledged also established the rule of law" (235). Therefore, South Africa maintained an independent judicial system that was not tainted by overt government involvement, and instead allowed for legal principles to guide their legal decisions.

This respect for the rule of law also implied that corruption levels were relative low. As Jonathan Hyslop explains in *Political Corruption: Before and after Apartheid*, although there were high patronage levels, "corruption was somewhat constrained by the legal fetishism that was characteristic of Afrikaner nationalist ideology in this period" (781). This would mean that "even the most dire apartheid measures were carried through with punctilious legal formalism, and the actions of civil servants were scrutinized by their superiors with this in mind" (781). Given these elements, it can be inferred that the relative governance for the apartheid regime was higher than other target states affected by sanctions regimes.

Finally, South Africa maintained a regulatory system of the highest caliber in support of their efforts to keep in place the apartheid system. As explained by William H.

Kaempfer in *The Economics of the Call for Anti-Apartheid Investment Sanctions,* the apartheid system "traditionally consisted of two distinct principles": (i) "political doctrine of separation that permits blacks to own land only in the African reserves (homelands) and that allows blacks temporary residence in white areas" according to their employment and (ii) the principle that "white labor in the industrial work force should be protected from black competition" (529). In order to maintain these principles, the South African government implemented various policies such as the "homelands policy" that diverted "black urbanization away from 'white' cities toward distant dormitory towns from which in-migration for black workers is costly" (529). Furthermore, a "chief instrument of regulation" that served "both principles" was the "system of influx control or 'passes,' which constrained black mobility, since passes were based on employment and all hiring had to be approved by state-run labor bureaus." According to Kaempfer, the "very existence of apartheid regulations, which embrace a comprehensive set of restrictions on black labor mobility, residential property rights and social interactions, gives clear evidence of state intervention in the market" (469). Interestingly, within these strict rules set by the government, the markets were allowed to function with relative freedom. Therefore, the South African government maintained a strong institutional framework with strict regulations that had to be followed by all members of society and which were strictly enforced.

Market Environment before Sanctions

Despite the strong regulation, South Africa was far from a planned economy as market forces were allowed to guide economic developments. As Rodman explains in *Sanctions Against South Africa,* MNCs subsidiaries were increasingly focusing on their self-interest and profit maximization in the domestic market as they not only "increasingly objected to and resisted the injection of foreign policy considerations into their business dealings" but "as overseas operations became more important to the firm, its managers came to identify more closely with host country rather than home country aims" (317). Therefore, before the sanctions were enacted, "corporate officials characterized their South African operations as apolitical and contended that they were [unfairly] being held responsible for injustices beyond their control" (317). Therefore, MNCs operated largely in a market friendly environment.

The Nature of the Sanctions

According to Joseph Hanlon in *Successes and Future Prospects of Sanctions Against South Africa,* sanctions to penalize South Africa for the apartheid regime started as early as 1977, following the "1976 Soweto uprising." The "massacre of the children in Soweto led directly to the sports boycott and the compulsory arms embargo imposed by the UN Security Council in 1977" (84). These sanctions were followed years later by more sanctions as "new uprisings inside South Africa in 1984 triggered new economic sanctions against the apartheid state in 1985 and 1986, particularly financial sanctions imposed by international banks and trade sanctions imposed by the US" (84). Thereafter, Nordic states "banned nearly all trade with South Africa," as many other states that began banning various commodities coming from South Africa. According to Hanlon, "Ireland banned South African fruit, France banned South African coal, etc. The Commonwealth (except Britain) banned the import of coal, steel, and agricultural products" while the "existing arms, oil and cultural bans were tightened" (88). Moreover, sanctions permeated the financial markets as international funds were pressured to divest from South Africa and "international banks refused to make new loans, and also refused to roll over (renew) old loans, leading to South Africa defaulting and refusing to pay its debts."

The sanctions were considerable. It is estimated that the US Comprehensive Anti-Apartheid Act resulted in a reduction in US trade with South Africa by $1.5 billion per year (88), with a cost to the country equivalent to 3 percent of GDP per year in the 1970s and 1990s (15). This would suggest that MNCs complied with the sanctions, as trade decreased substantially. However, further analysis is needed on the decision of MNCs to either comply with or evade the sanctions given the relative levels of penalties, incentives, and forgone profits.

MNCs Behavior after the Sanctions

The South African government went to a considerable length to induce firms to evade the sanctions. As Rodman explains, the "Protection of Business Act, which barred firms from releasing information about their operations without government approval, prevent[ed] South African private firms…from revealing relevant information" (211). This created obstacles for the sender state in implementing the sanctions as it made it more difficult for them to properly track the evaders of the sanctions. This in turn reduced the probability of MNCs being caught. Furthermore, under the "National Supplies Procurement Act, the South African government was able to commandeer any goods and services produced in South Africa regardless of a company's intentions" (209). Therefore, they were able to demand certain goods from companies that were subsidiaries of American MNCs, without the company being legally responsible for selling the goods under US laws, therefore "calling into question any commitment made by American firms to prevent the illegal end-use of their production." In other words, this Act "shield[ed] the companies from legal liability" since they "bore no responsibility for end-use unless they knew of its destination beforehand." This allowed the foreign subsidiaries of US firms to keep selling products in South Africa without the liability associated with the sanctions. These various initiatives show how the South African government was attempting to shield firms located in the country from the possible costs that the sender state could impose for the violations of sanctions. Therefore, MNCs faced a reduction in the cost of penalties imposed by the sender state for violating sanctions (S) and an increase in the cost of the penalties imposed by the target state for complying with them (T), increasing the incentives for MCNs to avoid sanctions.

Surprisingly, however, MNCs did not take full advantage of these measures and did not evade sanctions as much as possible. This development can be explained by the impact of governance not on the costs imposed by the sender and the target states for violating or complying with sanctions S and T, respectively, but on the other variable, FP, the foregone profits associated with sanctions. The particularly characteristics of South Africa, especially its market- friendly environment and open trade economy led MNCs to focus on the long-term consequences on their profits from evading sanctions. This was brought to the forefront because of the role played by interest groups, both domestically and abroad.

Soon after sanctions were enacted, MNCs began to be pressured not only by sender and target governments, but also by the local population, as well as by foreign interest groups as the inhumanity of the apartheid regime began to be better understood by the world at large. In other words, the imposition of sanctions galvanized interest groups further, which exerted pressure for more sanctions in an ever increasing movement that had an effect on MNCs' strategic decisions about whether to evade sanctions or not.

In order to better understand this development and their effects on MNCs operations, it is important to establish the relationship between interest groups and the sanctions regime. In Anton Lowenberg's *The Origins and Demise of South African Apartheid: A Public Choice Analysis,* he analyzes the impact of sanctions on domestic interest groups, focusing on the relationship between sanctions and strikes of black workers. Using a "vector-auto regression model the time-series analysis shows that an increase in sanctions had an immediate positive effect on the number of black workers on strike" (192). They also found that "there is some evidence to support the hypothesis that foreign sanctions, at least in the short run, helped domestic opposition groups organize collective action among their members." The sanctions brought together the international community against the wrongdoings of the South African government, creating a solid foundation for organizations within South Africa to consolidate and form a coalition with the international actors to put pressure on their government.

The respect for the rule of law, regardless of how immoral, allowed for the emergence of local interest groups, such as the United Democratic Front (UDF) and other activist organizations. Although the government of South Africa attempted to oppress these organizations within the boundaries of their legal system once they realized that they were a threat to their power, the creation of these organizations would have been a more arduous process under regimes with weaker governance. As stated in *Industrial Relations in South Africa* by Sonia Bendix, the early 1980s saw "the establishment of unions which found their power not only in shop floor organizations but also in gaining the support of the community" (190). The government had created an environment that was hostile to the creation of such organizations, and in an effort to live up to the high levels of regulatory quality, would even meet with certain unions. For instance, in "August 1981 and April 1982 representatives of the then emergent unions came together in Cape Town to discuss trade union unity" (192). Unlike other more autocratic regimes, the government at that time still wanted to portray as a country with high legal principles that accepted different organizations including labor unions. However, as these unions created the impetus for the eventual UDF and activist movements against apartheid, the government eventually oppressed these organizations, as they became threats to their power. Nevertheless, these organizations were able to use their transnational characteristics to gain support internationally and make it more costly for the MNCs to evade sanctions in South Africa.

Under these circumstances, resisting sanctions and not complying with the international pressure against the apartheid raised major opposition and put the long-term profits of the MNCs at risk. As noted by Lowemberg, MNCs operating in South Africa during this time were "forced to devote resources to defending and justifying a continued presence there" as furor grew abroad and some firms even had "certain corporate employees work[ing] full time on the South Africa issue, managing relations with concerned external stakeholders" (1635). As a result, many firms decided to do away with business with South Africa as "by withdrawing from South Africa, firms dispensed with the need to use resources in such a manner" and instead the resources could "be devoted to activities more directly associated with increasing profitability" (1635). As time progressed, these conditions worsened, and more firms decided that incurring these costs were not worth the benefit. Since "restrictions on firms operating in South Africa increased over time, firms withdrawing later became eligible for increasing amounts of previously barred business opportunities outside South Africa" (1635). When making these decisions, MNCs had to keep in mind the "net costs of withdrawing" which included the "expected future cash flows from South African operations minus the income from disposing of South African operations" (1636). As explained by Martin

Meznar in *Effect of Announcements of Withdrawal from South Africa on Stockholder Wealth,* as the "antiapartheid activism grew in the US," firms became increasingly aware and more likely not only to follow US sanctions but also to go above and beyond them by "not buy[ing] from, invest[ing] in, or work[ing] for corporations with affiliates in South Africa" (1635). Even local governments would begin "barring firms operating in South Africa from bidding on government contracts" such as in 1986 when "a committee of the Los Angeles city council refused to grant an engineer company a contract for upgrading the city's sewer system until the firm's parent company, Ashland Oil, pledged to withdraw from South Africa" (1635). Therefore, the impact for firms of continuing doing business with South Africa went beyond the direct profits gained from the business itself but also influenced the reputation of the firm which is an invaluable asset in today's globalized and informed society.

As MNCs reduced the level of businesses done with South Africa, the government began feeling the costs of the harm caused to its economic system. According to Schneider, the government not only felt that it had to suppress interest groups during this time, but also understood that "business owners and managers generally came to oppose apartheid" and that "the influence of political stability declined as the political costs of apartheid rose and it became a source of tension imperiling the stability it was supposed to protect" (31). These effects became increasingly problematic for the government as its economy plummeted, and the government slowly began to accept that "apartheid was inefficient and antithetical to economic growth" (31). Once coming to this realization, it was deemed that "free markets created by the removal of apartheid restrictions [were] a viable solution to South Africa's economic crisis" (31). Therefore, as the South African government began "placing prosperity above its other interests," the elite "would trade security for increased prosperity on the margin" (32). These implications made it difficult for the government of South Africa to maintain the institutional hold on the nation, and eventually the leaders were forced to accept that they had no choice but to dismantle the apartheid. With the help of Nelson Mandela and F.W. de Klerk, the South African government finally transitioned out of the apartheid regime, ending the apartheid's human rights violations and leading to the emergence of measures to protect civil rights and liberties.

Analysis

The case of South Africa provides an example of a target country in which governance was relatively strong, with a high respect for the rule of law, low corruption levels, and high regulatory quality, where the government tried to take advantage of this to reduce the impact of sanctions. Despite these efforts, sanctions proved to be extremely effective. As a matter of fact, these sanctions rank as one of the most effective sanctions regime ever implemented, according to Hufbauer et al.

The level of governance has an influence over the profits that are foregone by MNCs as a result of sanctions. For instance, in the case of South Africa, evading sanctions resulted in a larger impact in terms of foregone profits because of the pressure exerted by interest groups, both locally and abroad. Therefore, this case shows that MNCs not only focus on short-term foregone profits when making their calculations of whether to comply with sanctions or not, but also on long-term profits. This added element would imply that within the equation (2), FP would need to include considerations for both short and long-term profits.

Governance plays a role in this regard, because it is easier for interest groups to exert additional pressure over MNCs operating in a target country that has strong governance, including respect for the law, strong institutions, low corruption, and a strong and stable regulatory environment. Such countries tend to have stronger links to the external world and are generally market oriented. In such countries, the cost in terms of foregone long-term profits could be significant, inducing MNCs to go against their initial profit maximization objectives. Hence MNCs face not only the pressures from the sender and target states, but also the pressures from the market. The South Africa case helps display this as the high level of governance created different forces that eventually drove the profits of MNCs still operating in South Africa plummeting, leaving them with no choice but to stop doing business with South Africa.

The case of South Africa supports the initial link drawn in the statistical analysis that suggests that sanctions effectiveness is positively related to governance, calling attention to a broader definition of the variable foregone profits (FP) included in equation (2). In sum, the South African case proves that strong governance contains the seeds that undermine the incentive for MNCs to evade sanctions, regardless of the actions taken by the government of the target state.

In the case of South Africa, it was originally expected that it would have (i) a high level of private sector independence, (ii) strong prevalence of market forces, (iii) high penalties for evasion of the sanctions enacted by the sender state on the MNCs, (iv) low penalties for compliance of sanctions enacted by the target state, (v) low levels of forgone profit, and therefore (vi) high MNC compliance and high sanctions effectiveness. The findings showed that there was a high level of private sector independence and high penalties for evasion enacted by the sender state, but it has been difficult to demonstrate that there were low penalties for compliance of sanctions by the target state. As previously mentioned, there were many instances where the South African government attempted to intervene in the level of transparency, attempting to inhibit the sender state's ability to properly measure sanctions compliance, thus trying to reduce the actual level of S. However, these efforts were compensated by the actions of interest groups, which made it clear to MNCs that their long-term profitability was at stake if they attempted to evade the sanctions. Such development would not have been possible in a weak governance target country. Moreover, the MNCs were at first unwilling to comply with the sanctions as they wished to take an apolitical stance, not wanting to intermingle political implications with their economic profit goals. It was only after the arduous process of pressuring these MNCs through various means that they eventually felt it was worth to forego profits in the short-term and to divest or stop doing business with South Africa. Therefore, although it was a lengthy process, the MNCs eventually acted in accordance with the original hypothesis. Finally, the sanctions were effective, as evidenced by the eventual fall of the apartheid regime, resulting in an overhaul of reforms.

Iran

This case explores the sanctions imposed to Iran by the US in 1995 in response to their stepped up nuclear program and support of terrorist organizations such as Hezbollah, Hamas, etc. The Iranian case provides an apparent counterexample to the case of South Africa. Instead of having relatively high levels of governance and strong levels in the different dimensions, Iran has consistently demonstrated low levels of governance, being characterized by high levels of corruption and low respect for the rule of law. It must be noted that the role of MNCs was limited in Iran, and public enterprises with global reach dominated a large segment of the Iranian market, thus the pure profit maximization motives were secondary to the interest of the target state.

This case should be characterized by (i) a low level of private sector independence, (ii) weak influences of market forces and strong market controls by the government, (iii) low impact of penalties for evasion of the sanctions enacted by the sender state on the MNCs, (iv) high penalties for compliance of sanctions enacted by the target state, (v) high levels of foregone profits for not complying with the sanctions, (vi) low levels of MNC compliance and low effectiveness of the sanctions by each of the sanctions regimes

Background Information

Iran is the 18th largest country in the world in terms of land, and with around 75 million people, it is the 17th most populated country in the world. Its GDP is around US$ 480 billion with a GDP per capita of around US$ 6000. Iran is a member of OPEC and its economy is heavily dependent on oil production. It is a theocracy, with Shiite clerics exerting supreme authority over an elected government ran by officials of Islamic parties.

Governance Level

The level of governance in Iran is highly unique. Unlike South Africa, which at the time of the sanctions had developed strong governance as part of its efforts to maintain the apartheid apparatus in check, the Iranian government was less focused on forming institutions along the liberal western traditions. Instead, all government efforts were focused on strengthening the theocratic state, or the Iranian Revolution as they called it. With limited attempts to diversify the economy, the country remained captive of its oil dependence. As noted by Ryan Christopher Rilea in *Not So Splendid Isolation: An Analysis of Iranian Sanctions Busting,* "possessing such a vast amount of a valuable commodity comes with the usual trappings: corruption, profiteering and heavy involvement by other states" (34). Not only was corruption present, but the wealth provided by the oil-rich nation also created distorted objectives for the nation. According to Jeffrey Herbst in *On the Fault Line: Managing Tensions and Divisions within Societies,* the "spoils of corruption and patronage in Iran's oil-rich economy provide a strong incentive for those who control the levers of power to maintain and consolidate their position" (211). Iran was a country with little respect for international law, other than religious precepts, with rampant corruption, and an underdeveloped regulatory system because of public ownership of many sectors of the economy.

Market Environment before Sanctions

When the sanctions were introduced, Iran had a mixed economy dominated by oil production. After the revolution that took place in 1979, the Iranian economy became largely a centrally ran economy. A small private sector, mainly composed of family firms, was dwarfed by a large public sector that accounted for about 60 percent of the economy. The role of market forces in the economy was limited, not only because of public ownership of enterprises and the dominance of the oil sector, but also because of pervasive price controls and investment controls enacted by the government. As explained by Ali Farazmand in *Privatization Or Public Enterprise Reform?*, the 1960s were "marked by massive development of public enterprises in Iran" for many reasons such as "the strengthening of the state sector as a risk-free and stable economic partner for the western multinational corporations operating in less developed countries" (181). However, those projects were carried out with the cooperation of foreign firms, as "such projects were becoming of major interest to foreign corporations and the governments of the United States and Europe that found Iran an ideal country for political, military, and economic reasons" (181). In the eyes of the US in particular, Iran had all of the necessary elements for a good partnership. From an economic perspective, "Iranian oil was a big lubricant of the Western industrial-military and commercial machine which needed as much oil as possible" and Iran was seen as a "big consumer market for Western products," especially "after the great popular Revolution of 1978-79, the growth and expansion rate of public enterprises in Iran took a spiraling shape." This growth in public enterprises was due to a variety of different factors including that "the revolutionary government took a strong interventionist posture and undertook a massive number of public administration functions that were carried out through public enterprise management" (182). This led to the "growth and expansion of public enterprises in post-revolutionary Iran" and has had "tremendous impacts on the Iranian economy, work-force development, GNP, and public administration" (184).

During this time, these public enterprises were linked directly to the Iranian government. As Farazamand outlined, most "public enterprises [were] under the supervision of the Mostazafin Foundation—several thousand with a wide range of scope and nature of activities" that include "from commercial to production to building highways, bridges, dams, agriculture products and to airlines and insurance businesses" (184). Nevertheless, it is also important to mention that not all public enterprises were under the control of this "giant conglomerate organization." Moreover, throughout this time, there were some privatizations of enterprises "associated with traditional governmental departments and organizations," but they were "reported to have not been successful in meeting their economic goals due to legal, political, and economic reasons" (185). Farazamad illustrates that firms targeting the domestic market are more likely to fall under the scope of the government, and MNCs that attempt to operate outside of the Foundation's rules are forced to navigate a more difficult environment, as the government is able to impose different obstacles on their profit maximization efforts.

Nature of Sanctions

Iran has been the subject of a long history of sanctions following the Iranian revolution. After the revolution, the US enacted a number of sanctions, most of which are still in place today. Moreover, in May 1995, following Iran stepping up of its nuclear program with consistent support for what the US considered terrorist organizations such as Hezbollah, Hamas, and Islamic Jihad, the Clinton Administration issued Executive Order 12959 that banned all U.S. trade with Iran" (156). After that, the United States Congress passed the Iran–Libya Sanctions Act (ILSA), applying sanctions on companies doing business with Iran, and issuing a number of prohibitions to commercial links with that country.

According to Jeffrey J. Schott in *Economic Sanctions, Oil, and Iran,* these sanctions did not only affect direct trade but they also extended to an "estimated $4 billion in indirect trade, mainly by American companies selling oil in third countries" (6). When the sanctions were initially implemented, the international community had mixed views due to the important role that Iran played in global oil production. According to Schott, "French, German and British officials" called these US sanctions "the wrong approach and announced that they would continue their policy of 'critical dialogue' with the Iranian regime"(6). Therefore, these sanctions were at first imposed unilaterally by the US.

The situation changed in 2006, when the UN Security Council approved Resolution 1696, following Iran's refusal to halt its nuclear program. This resolution imposed sanctions on investments in oil, petrochemicals, gas, and petroleum products. Moreover, these sanctions were expanded to forbid business dealings with the Iranian government in the sectors of banking, insurance, shipping, and Internet services for commercial purposes. These sanctions were no longer unilateral, but included a commitment from the world at large.

Firms' Behavior after the Sanctions

Iran was well prepared to deal with the new sanctions due to the previous experience. When the Iranian government saw the its relation with the UN deteriorate to the point where the enactment of sanctions seemed almost inevitable, the government began expanding their underground networks that it had used until then to facilitate the sanctions evasion once they were implemented. According to Early in *Busted Sanctions: Explaining Why Economic Sanctions Fail*, a "large number of American firms already relied upon middle-men in Dubai to sell their products" before the sanctions were to be implemented, even for "goods that had not been sanction[ed]" (156). This was done in an effort to prepare for the sanctions that were to come, as the Iranians even "deliberately sought to become more reliant upon Emirati re-exports in the lead-up to the sanctions" (157). The Iranian government, with its direct influence on the profitability of the Iranian firms, planned for the sanctions ahead of their enactment.

Once the sanctions were approved, the Iranian government reacted strongly. As the sanctions "disrupt[ed] Iranian production, the stated-owned oil companies countered by self-imposing restrictions on foreign control over the oil extracting process" (157). The main priority of the government was to minimize the losses for the oil companies. To achieve this goal, Iran enacted a set of policies, which "centralized the operation of all domestic oil assets and ensured all revenue would flow to the government and not foreign firms." By doing this, the government centralized oil revenues in a single entry point, making the evasion of the sanctions more easily controlled, and allowing the firms to seek alternative sources for this revenue.

However, this was only the beginning, because the Iranian government undertook a series of initiatives after the sanctions enactment to cushion their effects on all firms located in Iran. Expanding the efforts already begun the prior year, Iran sought the support of other countries. According to Rilea, the Iranian government began the "courting of states outside the US sanction regime through the use of its valuable energy resources and the procurement of sanctioned goods through regional third party states" (157). One of the key actors during the time, the UAE, served as the main sanctions busters to Iran during these sanctions. According to Early, the "sanctions-busting conducted by the UAE on Iran's behalf during this period clearly involved significant levels of market-based trade—some legitimate and some illicit—and appeared to be driven largely by profit-seeking behavior" (145). In this case, the "UAE's close proximity to Iran, its explosively growing economy and heavy engagement in international commerce, and its close commercial ties with Iran" made it into "one of the most profitable venues from which to sanctions-bust on Iran's behalf" (175). According to Matthew Swibel in *Trading with the Enemy*, the UAE was able to re-export a significant percentage of the goods that it received from the US back to Iran. According to Swibel, more than "a quarter of the roughly $1 billion in American goods exported to Dubai ended up in Iran." In one year, export licenses could also serve as indicators of the increased help the UAE was providing to Iran, as export licenses jumped "47%" over the following years after the sanctions. The UAE was able to quickly maneuver its way to become the primary sanctions buster for Iran, once the Iranian government understood that it would need to find alternative avenues to maintain the profits for the firms. Therefore, the Iranian government was able to take advantage of the new status of the UAE at this time. According to the Wisconsin Project on nuclear arms control, in *Dubai:*

A Booming Entrepot and Growing Diversion Risk, Dubai became the "main entrepot of the Persian Gulf. It is what Singapore is to Southeast Asia and Hong Kong is to East Asia." In assisting Iran during the sanctions, the UAE also gained the recognition for being one of the most thriving and convenient trading hubs in the Middle East.

These sanctions busting transactions were done in an almost seamless manner. As explained by Taubman in *America's Hollow Embargo in Iran*, the process was fairly simple. Taubmann provides an example of a trader in Tehran that "telephoned an appliance company in the US and said he was calling from Dubai, a small Persian Gulf state. He placed an order for 1,000 washing machines, had them shipped to Dubai and then arranged them for payment from a Canadian bank where the Iranian had opened an account. Since the goods were shipped to Dubai, American custom agents raised no objections. Once the washing machines reached Dubai they were transshipped to Iran." In addition to simple consumer goods, Early explains that the UAE also "supplied Iran with sensitive dual-use and high-tech products" (159). According to Taubman, when these items were involved, the "Iranian traders contended that bribes had been paid to get particularly sensitive items by, including computer equipment and spare parts that can be used to maintain military equipment and missiles." The success of these practices and the concealing of the UAE's role is demonstrated by the fact that in the Specially Designated Nationals and Blocked Persons list maintained by the Office of Foreign Asset Control at the US Department of Treasury, only 1% or 3,032 separate entries were Dubai-based.

Iran could afford to pay for these activities because the benefits of evading the sanctions far outweighed its costs. A clear example of this is provided by the case of the company Juma Majid Co, one of Dubai's largest appliance wholesalers. According to Early, the CEO disclosed that his company had "smuggled/re-exported roughly 60-70%

of its stock of GE appliances to Iran" (157). The CEO understood that "abiding by the new US sanctions would cost his company a substantial portion of its business" and even questioned whether the GE American partner had "genuine interest in his company's compliance" (157). This analysis clearly demonstrated that the "company had no incentive to comply with the harsher new sanctions unless the US government could credibly threaten retaliation for violating them in ways that would diminish the sanctions-busting's profitability" (157). Therefore, this also created a view within Dubai that the US government "would not punish sanctions busting violations, and, with profit margins as high as 40% on the sanctions-busting transactions being conducted, the risk was well worth taking" (157).

As a result, it is not surprising that the 1995/96 sanctions were deemed to be relatively ineffective, contrary to the UN-imposed sanctions of 2006 due to its nuclear program, in an extraordinary show of unity by the world at large.

Analysis

This case of the Iran sanctions in 1995 provides additional support for the analysis above that stresses that MNCs serve as the causal mechanism behind the link between governance level and economic sanctions effectiveness. This case not only confirms that a target state with a low level of governance can achieve low levels of sanctions effectiveness as shown in the statistical analysis, but also helps illustrate how the actions of the MNCs can provide a causal mechanism for this link. As a result, the case of Iran provides additional support for the hypothesis of this thesis. In this case the target country has weak governance and the result is as expected: low sanctions effectiveness as a result of MNC activity.

This case makes it clear that the equation (2) continues to explain the forces that guide firms' reactions to the sanctions, even when MNCs are not prevalent, market forces are weak, and the relative influence of target and sender state is different than in the South African case. Iran firms were more protected from the reach of the sender state, and more vulnerable to the reach of the target state. Moreover, in a country with the characteristics of Iran, market forces and the long-term impact on profitability have limited importance. Therefore in such an environment, firms perceive the cost of penalties imposed by the sender state as being relatively small when compared with the short-term foregone profits and the cost that could impose the target state for compliance. The existence of corruption makes it even easier to evade sanctions, thus further reducing S. Again, the level of governance is the variable that allows firms to react in a certain way to the imposition of sanctions.

At the same time, it should be recognized that the cost of reducing S becomes more and more expensive as time passes. Eventually, the sender state becomes aware of the leakage points, and takes action to oppress them. A clear example of this includes the efforts taken by the US to seek the support of the world at large to sanction Iran, resulting in the UN sanctions of 2006.

In summary, weak governance with increased levels of corruption and low levels of respect for the rule of law allowed the target government to have significant control over the operations of the firms. In this case, these were mainly public enterprises rather than MNCs, which maximized profits for the benefit of the state. With such an enormous degree of government control, corruption was rampant, and there were no market forces to put a limit to it because the country was isolated from international trade other than through oil exports. However, the same factors described in equation (2) were at play when it came to the implementation of sanctions and the results accordingly.

According to the initial hypothesis, this case should have shown (i) a low level of private sector independence, (ii) weak market forces, (iii) low actual penalties for evasion of the sanctions enacted by the sender state on the MNCs, (iv) high penalties for compliance of sanctions enacted by the target state, (v) low level of MNC compliance with sanctions in the target state, and (vi) low effectiveness of the sanctions by each of the sanctions regimes. As discussed, variables (i) and (ii) were clearly outlined, as the Iranian government insisted on being heavily involved within the markets and made it often difficult for firms, even those that had gone through the process of privatization, to fully thrive. In terms of (iii), the penalties enacted by the sender state, the US failed to adequately enforce their sanctions regime, only detecting a few of the evasions that occurred through the UAE, and therefore was unable to deter firms from finding alternate ways of conducting trade with Iran. Nevertheless, as the sanctions progressed, the level of penalties began increasing. Regarding the penalties enacted by the target state (iv), although the Iranian government imposed high levels of penalties for firms that complied with the sanctions and made it difficult for the sender state to gain the information needed to monitor the relevant sanctions evasions, it also added benefits to the sanctions evasion. By reaching out to foreign countries and enabling firms to easily evade the sanctions through the use of mostly illicit trade with the UAE, the government not only increased the cost associated with complying with the sanctions but also added to the benefit side of the cost-benefit analysis as evading the sanctions resulted in entering new markets. As shown by the evidence as mentioned above, there was low level of compliance as firms were able to maintain their profit levels high as a result of the alternate trade made available through the UAE and other sources. Therefore, as demonstrated by the Hufbauer data in their index of sanctions effectiveness for this case, the Iran sanctions were relatively unsuccessful, as the leaders did not make the concessions that were sought.

Country Cases: Summary of Results

The conclusions derived from the analysis of these two country cases can be summarized in the table presented below, which displays the relative levels of governance, regulatory quality, freedom from corruption, and sanctions effectiveness.

Year	Sender State	Target State	Governance Level	Regulatory Quality (1)	Freedom from Corruption (2)	Sanctions Effectiveness (3)	Consistent with hypothesis?
1995	US	Iran	121	4	29	0	Yes
1986	US	S. Africa	377	63	50	2	Yes

Notes:

(1) Regulatory Quality: From 0 to 100 (high regulatory quality)
(2) Freedom of Corruption: From 0 to 100 (free from corruption)
(3) Sanctions Effectiveness: From 0 (failure) to 2 (success)

The results support the existence of a positive relationship between the level of governance in the target state and the effectiveness of the sanctions regime. Furthermore, as outlined by the case studies mentioned above, there is clear evidence in support of the hypothesis that the cost-benefit analysis of firms during these sanctions regimes could serve as causal mechanisms for this link.

SECTION 7: Conclusion and Policy Lessons

Economic sanctions have become a critical instrument of economic statecraft. They are extremely useful mechanism designed to exert pressure on other countries without recourse to more extreme and costly actions, such as war. However, despite their increasing popularity, there is a growing understanding that sanctions effectiveness is somewhat limited. A vast literature has analyzed this development and has identified a number of factors that undermine the effectiveness of sanctions, including lack of international cooperation, prior relations between sender and target states, the average cost of sanctions, the existence of trade linkages, etc. The majority of these studies were conducted from a macro point of view, stressing the role played by the governments, therefore, they failed to delve into the microelements that lead agents to comply or not with sanctions. This is an important drawback because in recent years, there has been increasing awareness that in a globalized world, the main actors in the implementation of sanctions are the MNCs that handle international trade. Understanding the factors that influence the decisions of these MNCs is essential to understand what determines sanctions effectiveness.

This thesis attempts to make a contribution towards explaining the effectiveness of sanctions by focusing on the factors that influence the actions of MNCs when it comes to implementing sanctions. In analyzing these factors, it has become evident that the environment in which firms operate plays an important role in their actions. Among the determinants of this environment, the governance of the target state holds important implications for the eventual effectiveness of the regime as a whole. This thesis focuses on this factor, seeking to understand the microelements that explain the relationship between governance in the target state and sanctions' effectiveness. Approaching the problems from three different perspectives (analytical, statistical and country cases), this thesis found support for the hypothesis of a positive relationship between governance in the target state and sanctions effectiveness. This outcome reflects the strategic choice planning of the MNCs located in the target state in response to the imposition of sanctions. The findings of this thesis support the view that the stronger the governance in the target country, the more likely that sanctions would be successful and vice-versa.

These conclusions have important policy consequences. Sender states need to take into account the governance in the target state as they design a sanctions regime. When sanctions are applied to a country with strong governance, the sender state should expect relatively quick and strong results from the sanctions, while if they are applied to a weak governance country, poorer results and delays should be expected. Furthermore, in tailoring sanctions to target states with low levels of governance, a number of considerations must be taken into account regarding the target country, including how to deal with its informal channels, corruption, and strong business linkages with partner countries. Accordingly, the sender country could afford a more hands off approach in the case of sanctions to countries with strong governance, but would need a more proactive approach when dealing with a weak governance country. This has important implications for the design and implementation of extraterritorial controls.

This thesis also highlights the dilemma faced by target states that are trying to implement actions aimed at fostering development. There is ample evidence that strong governance is good for the economic, social and political development of countries. However, this thesis highlights that strong governance makes a country more vulnerable to the use of economic statecraft. Especially for certain target states that would be possibly susceptible to economic sanctions in the future, this finding could make them less willing to actively pursue reforms to strengthen governance, thus undermining their development policies.

In sum, this thesis brings into the discussion a new variable that could help explain the effectiveness of sanctions. In this context, it could be argued that this thesis makes a contribution to the sanctions literature as it suggests the need to focus on additional factors to make sanctions more effective. Strengthening the effectiveness of sanctions is important not only because of statecraft purposes, but also because of the associated costs. Sanctions could exert a heavy burden on the population of the target state. Therefore, making sanctions more likely to achieve their results with limited pressure, in terms of coverage and duration, could reduce the cost of the sanctions for the population of the target state. As many target states are undergoing efforts of development, reducing this cost could provide for higher levels of social efficiency moving forward.

Appendix: Economic analysis of impact of trade sanctions

According to David Rowe in *Manipulating the Market,* trade sanctions will "fall into four categories" as they may be applied "against countries that are small on world markets (price takers)" or "against countries that are large on world markets (have market power)" and within those two they can be applied "either on that country's exports or on its imports" (20). When analyzing effects of a sanction against a small country's exports, Figure 1 can display how the target country's economy will be altered.

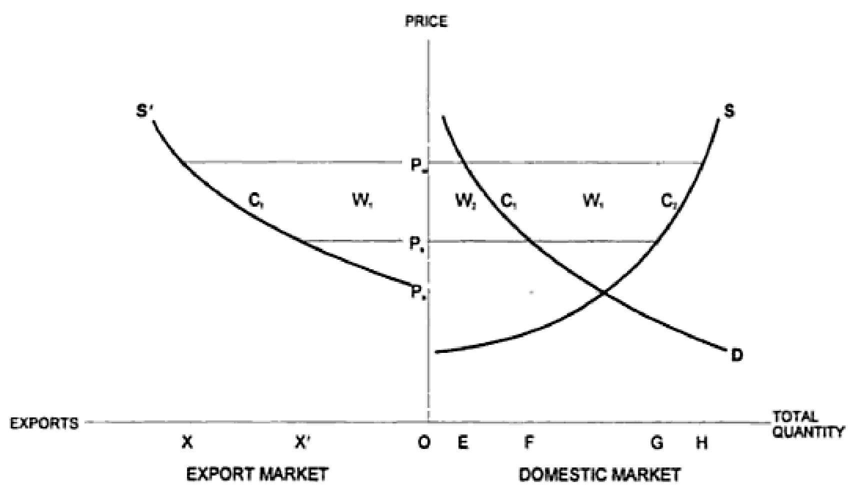


Fig. 1. An export sanction

The left hand panel signifies the "target country's external market for exports" and "relates the quantity of exports supplied to world markets to price by tracing out the difference between the domestic supply and demand schedules given in the right-hand panel" (21). At the "autarky price, Pa, exports will be zero because domestic demand equals supply" yet as world price rises, supply "Exceeds domestic demand and the quantity of export rises" to arrive at Pw (21). Once some of this country's trading partners impose a boycott, this will "segregate foreign importers into two groups: those that participate in the boycott (X'X) and those who do not (OX'). This will result in "domestic exporters perceive[ing] the boycott as a drop in demand and respond by competitively lowering prices to secure sales to importers who remain in the market" (21). Therefore, although the world price does not change, it "drives a wedge between the prevailing world price Pw, and the sanctions-depressed price obtained by this country's exporters Ps" (21). When reverting this to MNCs who will be the producers in this scenario, the "slackened demand for exports causes production to fall from OH to OG, and price to fall form Pw to Ps" also leading to a "loss of producer surplus inflicted by the sanctions, shown as the "sum of C1 and C2" (22). Furthermore, the economic cost of the boycott "to the target economy consists of the deadweight welfare costs created by the sanctions plus the economic windfall that is captured by those foreign importers still serving this market (Ct+W) while the cost to "target country's exporters" which represent MNCs is "even larger consisting of the entire sum of deadweight costs and windfall transfers (Ct+W1+W2)."

This is a different case than the analysis for sanctions that are focused on the small country's imports. Looking at figure 1, import sanctions differ as they have an upward sloping demand curve for the import markets as opposed to the export sanctions, which had a downward sloping supply curve. Therefore, the sanctions price would be below the autarky price and above the world price. This would "reduce target country's imports" and "create a domestic shortage that propels their price upward to Ps" (28). Like a boycott, "the embargo imposes deadweight welfare costs and windfall transfers" (28).

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