

The Moderating Effect of Bilateral Investment Treaty Stringency on the
Relationship between Political Instability and Subsidiary Ownership Choice

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ABSTRACT

We investigate whether the degree to which a bilateral investment treaty (BIT) protects against expropriation (i.e., its “stringency”) influences the international strategy of multinational enterprises (MNEs) as they invest in countries with varying levels of political instability. We draw on institutional logic and insights from political economics to hypothesize that BIT stringency will moderate the established positive relationship between host country political instability and minority ownership. Analysis of a sample of 289 foreign investments made by AEX-listed Dutch MNEs in 34 countries between 2004-2013 provides support: a more stringent BIT will encourage the MNE to choose a majority stake as political instability rises. Robustness tests provide further support for our argument. The results have both managerial and policy implications relating to the role that BIT stringency plays in determining MNE strategy.

Key Words: political instability, bilateral investment treaties (BITs), subsidiary ownership choice

1. Introduction

Developed industrialized countries can use bilateral investment treaties (BITs) to protect the rights of their companies as they invest in uncertain markets. Developing and emerging countries, on the other hand, sign BITs in order to attract inward foreign direct investment (FDI) (Neumayer & Spess, 2005) and compete for a share of the world's FDI (Elkins, Guzman, & Simmons, 2006). Political uncertainty in host countries renders BITs useful as a source of information about the treatment of multinational enterprises (MNEs) and protection of their assets in such countries.

Scholars have argued that BITs can mitigate political instability by offering credible and enforceable international legal protection of foreign investors' rights (Mulchinski, 1995; Raghavan, 1997; Rosendorff & Shin, 2015; Sornarajah, 2004; Wälde, 2005). There is a growing evidence that the *presence* of BITs encourages FDI and reduces the likelihood that host governments will engage in policies harmful to MNEs (e.g., Desbordes & Vicard, 2009; Elkins, Guzman, & Simmons, 2006; Jandhyala & Weiner, 2014; Neumayer & Spess, 2005). However, research on this has yielded mixed and conflicting results (Kerner, 2009). Subsequently, scholars have begun to question how the *content* of BITs influences FDI across countries (Anzorena & Perry, 2010; Berger, Busse, Nunnenkamp & Roy, 2010).

Unfortunately, answers to the question of how the design and content of BITs influence MNE strategy have not yet been provided by international business (IB) research. There is little empirical evidence on how BIT provisions may be associated with MNE market entry strategy. Research on the institutional determinants of MNE strategy in the field of IB has mainly focused on other country-level institutional conditions that influence MNE internationalization decisions. Examples of these include: legal restrictions on FDI in the host country that influence use of joint

ventures (Brouthers, 2002), how institutional progress in transition economies is related to MNEs choosing full ownership modes (Meyer, 2001), and the impact of institutional distance between home and host country on joint venture formation (Gaur & Lu, 2007). The IB literature on international strategy does not, by and large, include treatment of international investment agreements (IIAs) such as BITs in theoretical or empirical work¹. De Villa, Rajwani and Lawton (2015) recently noted the absence of focus on multi-levels of the political environment in market entry studies.

In this study, we address this research gap and build on recent research highlighting the *content* of IIAs as a determinant of FDI (Berger et al., 2010; Büthe & Milner, 2014; UNCTAD, 2014) *as opposed to the mere presence of such agreements*. More specifically, we investigate the impact of *BIT stringency* on ownership choice. We define BIT stringency as the degree to which the provisions within the BIT agreement legally protect signatory-country investors against expropriation. Some BITs are more protective of foreign investors than others in terms of types of potential expropriation (direct and/or indirect, i.e., creeping expropriation) (Wei, 2015), flexibility of investment dispute settlement mechanisms, compensation for expropriation, and other expropriation provisions (Lukoianova, 2013). BITs also differ in terms of whether they allow dispute resolution through the International Centre for the Settlement of Investment Disputes (ICSID) (Allee & Peinhardt, 2010).

BIT stringency is a critical aspect of the broader international institutional environment that guides subsidiary ownership choice, particularly in politically-unstable countries. This paper offers an argument explaining the impact of BIT stringency on subsidiary ownership choice under differing levels of political instability. By drawing on institutional theory and recent

¹ One recent exception is Jandhyala and Weiner (2014), who demonstrate how MNEs place a higher value on foreign assets protected by international investment agreements than those that are not protected at an international level.

insights from international political economy (IPE) research, we hypothesize an indirect influence of BIT stringency on subsidiary ownership choice: at higher levels of political instability, a “stringency” effect comes into play that provides much needed “reassurance power” regarding international asset protection, inducing investing firms to choose majority ownership over – what would otherwise be - minority ownership. To date, there have been no empirical studies of the contingent relationship between BIT stringency, political instability, and ownership choice. Our empirical analysis is based on 289 foreign investments made by AEX-listed Dutch MNEs between 2004 and 2013 into 34 countries with which The Netherlands had a ratified BIT. Controlling for a range of firm-, country- and industry- factors, we find support for our hypothesis.

Our study contributes to the existing literature on MNE internationalization strategy in two important ways. First, we explain the linkages between the *design elements* (BIT stringency) of an institutional arrangement at the international level (as opposed to a domestic institutional arrangement within the borders of one country) and MNE international strategy. Secondly, we advance understanding of how international institutions and country-level conditions interact by examining the impact of BIT stringency on MNE choices as levels of political instability vary across host-country environments. To our knowledge, our research is the first study to examine the role of BIT stringency in this way.

2. Background and hypothesis development

2.1 Host country policy uncertainty and subsidiary ownership choice

Scholars have argued there is a strong impact of uncertainty in host-country policy on subsidiary ownership choice in the country; the greater the uncertainty, the more likely an

investing MNE will choose minority ownership as opposed to a majority ownership or a wholly owned subsidiary (Xu and Shenkar, 2002). Why is this? A country exhibiting a strong regulatory institutional environment, that is, fundamental legal ground rules that are stable, transparent *and* enforced, inspires confidence in the country's investment environment, such that economic activities that occur within its borders can flourish (Holburn & Zelner, 2010; Li & Zahra, 2013). Contracts can be enforced; transgressors can be pursued in a functioning court of law. In such politically-stable environments, government leaders have a limited ability to make abrupt and discriminatory policy changes that might adversely influence MNE strategy (Wei, 2015). In such an environment, external uncertainty -- exogenous to the firm -- is diminished.

When it comes to more unstable countries – such as those in the developing world and at the transitional periphery (Wood & Demirbag, 2015) - the impact of politics is more prominent. Political systems represent agents of institutional change in such countries (Henisz, 2002; Peng, 2003). When political instability arises, the potential exists for an unexpected change in the set of external forces that influence the MNE's investment in the country. As noted by Eden and Molot (2002), MNEs “actively attempt to shape government policies toward their industry” (Eden and Molot, 2002: 367). Instability in the political environment of a host country increases the likelihood of corresponding turmoil in this policy environment (Peng, 2003). In the presence of political instability, an investing MNE then will face a greater challenge in its ongoing bargaining discussion with numerous actors in the host country (Henisz & Zelner, 2005) as it prepares for investment. As MNEs engage in bargaining in this type of environment, political actors can “overturn, alter or re-interpret emerging institutions” (Henisz & Zelner, 2005: 373) at short notice. Government actions also can attempt to alter the distribution of wealth by means of nationalization, taxation, and money supply regulations. In this context, bargaining becomes

troublesome because politicians can be “ambivalent, and sometimes contradictory, in driving economic reform agendas” (Wood & Demirbag, 2015: 1). In other words, the lack of checks and balances associated with political instability will reinforce the possibility that regulations themselves will be hard to predict and invested assets harder to protect. Abrupt changes in the political environment can cause potential financial loss for firms, as well (Henisz, 2000). Research has highlighted the vulnerability of MNEs in these circumstances (Czinkota, Knight, Liesch, & Steen, 2010).

Choosing minority ownership can alleviate these concerns by improving the MNE’s ability to learn about emerging (and changing) institutions while limiting commitment (Pak & Park, 2004; Xu and Shenkar, 2002). Indeed, several studies have reached similar conclusions on the relationship between political uncertainty and subsidiary ownership choice (Brouthers, 2002; Demirbag, Glaister, & Tatoglu, 2007; Gatignon & Anderson, 1988).

2.2 Content of bilateral investment treaties

We argue that this relationship between political instability and subsidiary ownership choice will be moderated by the content of any international investment agreement (IIA) – such as a BIT - between the home and host country, in particular, the content associated with the protection of international investments. We focus on BITs as they are the most prevalent form of bi-lateral investment agreement although our argument may apply also to other forms of international investment agreement such as investment provisions in regional economic institutions.

According to the United Nations Conference on Trade and Development (UNCTAD), there are currently 2,279 ratified BITs in force, compared to 280 other forms of IIA between countries (UNCTAD, 2015). It has recently been argued that more autocratic countries – with much to

gain from FDI - will sign BITs to add credibility to investment promises they make to outside investors (Rosendorff & Shin, 2015). As noted by Wei (2015): “Bilateral investment treaties (BITs) regulate the exercise of the state’s power to expropriate investments” (Wei, 2015: 579).

Scholars have noted divergence in the content of BITs across all types of countries (Berger et al., 2010; Sachs & Sauvant, 2009; Sornarajah, 2004). In other words, not all BITs are the same. Freyer and Herlihy (2005) observed that “[s]ome states are... more explicit when drafting and negotiating new investment treaties” (Freyer & Herlihy, 2005: 83, footnote 89). Differences in the content of BITs arise because of the different motives that stakeholders have for developing provisions within a BIT. While BITs were historically concluded between capital-abundant advanced industrialized countries and capital-scarce developing countries (Sornarajah 2004), there has been an increase in BITs between developing countries. A capital-exporting advanced industrialized country will attempt to increase, as much as possible, international rights protection for their investors through BITs. Developing and emerging countries, on the other hand, despite competition for a share of global FDI (Elkins, Guzman, & Simmons, 2006), will attempt to keep their sovereign rights as much as possible to control FDI on their territory.

BITs differ in terms of the inclusion and strength of investment provisions (Berger et al., 2010), the number of obligations specified, the scope of their coverage, and the amount of details the obligations provide on every issue (e.g., Hallward-Driemeier, 2003; Sornarajah, 2004). Some BITs are more stringent than others. *BIT stringency will be higher when the content of the BIT offers better protection against unforeseen and damaging events, including expropriation of assets.* The content of a BIT is the result of a rigorous analysis undertaken not only by government officials in each country, but also by domestic business representatives with interests in the countries. Often a non-binding Trade and Investment Framework Agreement (TIFA) is

signed, under which two countries create a joint council responsible for the identification and discussion of all pertinent investment issues. This allows corporations an opportunity to express their concerns and demands regarding particular BITs. After signing, both countries have to follow domestic procedures to ratify BITs. Without ratification, a BIT has no legal force to protect foreign investors in a host country (Yackee, 2009).

Researchers, predominantly in IPE, have only recently begun to examine the links between the content of international investment agreements and FDI outcomes. Bütte and Milner (2014) examined FDI flows into 122 developing countries and showed that stronger mechanisms for credible commitment in preferential trade agreements (PTAs) induced FDI. Berger et al. (2010) used a four-value ordinal variable to capture the strength of provisions in BITs and regional trade agreements (RTAs)¹. While these authors find a positive relationship between liberal admission rules² in RTAs and FDI, their findings in respect of BIT provisions influencing FDI are inconclusive³. In addition, UNCTAD has noted that substantive treaty provisions lie behind the FDI impact of international agreements between countries (UNCTAD, 2014). While these recent studies suggest that the content of IIAs can play a role in FDI decisions, there has been no research on this in the MNE strategy literature.

2.3 The indirect impact of BIT stringency on subsidiary ownership choice

We assert that the level of BIT stringency will moderate the relationship between political instability and subsidiary ownership choice. Scholars note that IIAs such as BITs signal

¹ This variable ranged from 0 for weakest (country pairs not bound by any national treatment obligation) to 3 for strongest (agreements with a detailed list of ways in which a host country may discriminate against a foreign investor) (see Berger et al., 2010, p.7)

² Liberal admission provisions “restrict the ability of host governments to discriminate with respect to the admission of foreign investments” (Berger et al., 2010, p.1)

³ Berger et al. (2010) report GMM estimations that show a positive relation between BITs without national treatment provisions and FDI at the 10% level

credible commitment by a host country to protect rights of foreign investors. Private economic actors seek credible commitment when entering a host country, a commitment being credible if the actor believes it is rational for other actors “to do what they say they will” (Martin, 2000; 14; Büthe & Milner, 2014: 91). Credibility in this sense refers to “*expectations* about the future actions of strategic actors” (Diermeier et al., 1997: 22), and commitments become more or less credible “depending on the magnitude of the costs imposed on future deviations from the promised actions” (Diermeier et al., 1997: 23). Credible commitments “raise ex post costs of non-compliance above those that might be incurred in the absence of a treaty” (Elkins et al., 2006: 823). In addition to legal costs and potential compensation payments through an international arbitration tribunal, further costs for the host country in the event of non-compliance can include reduction in future inward FDI, making future co-operation with MNEs more difficult and reputational damage (Elkins et al., 2006; Büthe & Milner, 2014) This line of argument and supporting empirical evidence indicate that investors do take the presence of these agreements into account when preparing for FDI (Büthe & Milner, 2014). Observers have noted how foreign investors can implement risk-management strategic planning using BITs (Anzorena & Perry, 2010). Sachs and Sauvart (2009: *lv*) note that firms “deliberately seek the protection of a treaty” when they engage in treaty shopping. Other scholars argue that while investors may not necessarily refer to BITs when making location choices, they will do so in the potential event of a dispute (Poulsen, 2010).

We argue that the more stringent the content of the BIT, the more credible it will be in deterring adverse government actions, all else equal, as a result of political instability in a host country. While the *presence* of a BIT can induce compliance by clarifying the commitment, involving the home country government and enhancing enforcement (Elkins, Guzman &

Simmon, 2006: 823; Rosendorff & Shin, 2015), the *stringency* of a BIT will determine the strength of credibility in the commitment to protect property rights of foreign investors. It will do this by raising greater *ex post* costs for the host country than would otherwise be incurred in the event that a host country does not comply with the BIT's stipulations. The investing MNE receives a stronger guarantee *ex ante* and in writing about the conditions under which a third-party international dispute mechanism would be triggered if contractual disagreements arise at some time in the future. While some BITs (such as the Peru-China BIT) regulate against direct expropriation, as noted by Wei (2015), some BITs go further and regulate also against indirect *and* creeping expropriation. Büthe and Milner (2014) refer to this increase in stringency in terms of clauses that have a greater "reassurance power" for the investing MNE.

As the level of political instability in a host country increases, the need for sources of such reassurance power surrounding any proposed MNE investment will increase. The MNE will be alert to the potential adverse consequences of increasing political instability and will seek out reassurance that any investment will be protected. As political instability rises, the MNE will seek comfort in what is essentially an increasingly uncomfortable investment situation. Consequently, the impact of BIT stringency on the relationship between political instability and ownership will be determined by the requirement for such reassurance power over and above that which is received by other sources of reassurance, including the mere presence of any BIT. This reassurance power of BIT stringency is all the more pertinent because BIT content is a manifestation of the interests of forceful interest groups (namely the home and host country governments, as well as international courts of arbitration) while representing a category of 'checks and balance' (in Henisz & Zellner's (2005) terms) that will dampen the impact of political instability on abrupt and potentially damaging changes for foreign investors.

In these circumstances we expect a more stringent BIT to offer greater reassurance and protection to investing MNEs, providing them with encouragement that majority ownership in the face of abruptly changing national institutions is still viable (Büthe and Milner, 2014). Looking at this from the opposite angle, as political instability *decreases*, the need for additional reassurance power through BIT stringency will diminish. MNEs will need less protection against potential expropriations and the threat of hostile government confiscation of assets is lower. We therefore propose an interaction effect, stated as follows: *BIT stringency will moderate the positive relationship between host country political instability and likelihood of choosing minority ownership: as political instability increases in a host country that has ratified a BIT with the home country, BIT stringency will reduce the likelihood that MNEs will choose minority ownership in that country.*

3. Methodology

We collected data on new foreign investments made by 22 MNEs listed on the Dutch AEX index (Amsterdam Exchange Index) in 2004 and continued to pool the data on these companies over the ten-year period 2004-2013 inclusive. The new investments were strategic investments outside the Netherlands that were not simply an equity extension of a previous equity investment in a given location in a host country. For the current study, we selected those made in host countries where there was a ratified BIT in place between The Netherlands and the host country. We note that sample countries included a range of developing as well as some newly industrialized countries. This allowed us to obtain adequate variance in political instability. The 34 countries in the sample that satisfied these criteria are shown in Table 1 categorized by their World Bank Governance Indicator percentile rank for political stability.

Table 1 about here

Dutch businesses have had a long history of internationalization, starting with Dutch traders in colonial times, right up to the present day (Wilkins, 2005). The Netherlands is a small, but globally open, economy, and, according to the UNCTAD International Investment Agreements Navigator, currently has BITs ratified with 96 countries (UNCTAD, 2014). Against the backdrop of the recent global financial crisis, Dutch firms are increasingly shifting focus towards developing and emerging countries (Holland Trade, 2014). The Netherlands was also one of the world's top ten countries in terms of numbers of BITs in 2007 (Sachs & Sauvant, 2009). These features made The Netherlands an ideal country to target as the home country for sampling. AEX-listed MNEs were chosen for this study because: (1) as large MNEs they have widespread international operations and are active in a range of host countries; (2) AEX-listed MNEs' annual reports are audited and contain their most important and strategic foreign investments clearly reported. The reports were obtained from corporate websites. Previous researchers of MNE internationalization have used company reports as the main data source (e.g., Gatignon & Anderson, 1988).

To enhance reliability, we used press releases from the sampled MNEs in order to identify ownership in ambiguous cases. Observations that remained unclear or were considered to be very small portfolio holdings were not included in the final sample. The final sample size was n=289, corresponding to an average of 28.9 new foreign investments per year.¹

Dependent variable. We coded two ownership structure choices: majority ownership (1) and minority ownership (0) (Chen, 2008). Where the equity stake was explicitly reported, we treated

¹ The distribution of observations over the ten years was as follows (number of observations and percent of total sample in parenthesis): 2004 (n=30, 10.4%), 2005 (n=32, 11.1%), 2006 (n=53, 18.3%), 2007 (n=42, 14.5%), 2008 (n=47, 16.6%), 2009 (n=3, 0.7%), 2010 (n=12, 4.2%), 2011 (n=37, 12.8%), 2012 (n=14, 4.8%), 2013 (n=19, 6.6%).

majority ownership as 51% or greater stake. We follow previous researchers such as Filatotchev, Stephan & Jindra (2008) and Pedersen and Thomsen (1997). Filatotchev, Stephan & Jindra (2008) use “a dummy variable for the foreign investor’s ownership above the controlling threshold of 51%” (p. 1140). Pedersen and Thomsen (1997) define majority ownership as greater than 50%. Ramaswamy, Gomes and Veliyath (1998) state that 51% or greater represents “a pattern of ownership indicating majority control” (Ramaswamy, Gomes, & Veliyath, 1998: 437). Our approach here is also consistent with the narrative on ownership of foreign investments given in the annual reports we reviewed. For example, TNT Express defined subsidiaries as those entities where the firm had control over financial and operating policies, “generally accompanying a shareholding of more than one-half of the voting rights” (TNT Express, 2013: 78). Similarly, ArcelorMittal referred to a 55% stake in Belgo Bekaert Arames (Brazil) as a “controlling stake” (ArcelorMittal, 2013: 80). Any unclear or ambiguous cases which could not be clarified by reference to press releases were left out.

Independent variables. We operationalized political instability using the World Governance Indicator for political stability and absence of violence, reverse coded (Globerman & Shapiro, 2003; Knack & Keefer, 1995). This indicator measures the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, from the frequency of violent demonstrations, social unrest, conflicts of an ethnic, religious or regional nature, to whether the country suffers from a sustained terrorist threat. The theoretical range is from -2.5 (highest instability) to +2.5 (highest stability). We reverse coded the variable so that it captured political *instability*. The actual range in the data is from -1.11 to 2.11.

We used a new measure for BIT stringency that captures the degree of legal protection from expropriation (Lukoianova, 2013). Appendix 1 provides technical details on how BIT

stringency was calculated. The degree of protection from expropriation is measured as the cosine similarity measure between every BIT ratified between the Netherlands and the host country and the BIT of a chosen benchmark (or a measurement standard) of a maximum legal protection for a foreign investor from expropriation. We used the cosine similarity measure over the alternatives (Jaccard's coefficient, Sorensen's coefficient, and Ochiai's coefficient) as it has been demonstrated as one of the "top performing" similarity measures for text document clustering (Strehl, Ghosh, & Mooney, 2000). Research in natural language processing has also demonstrated advantages of using the cosine coefficient to identify whether two text units are more or less similar in their context (Jurafsky & Martin, 2008; Manning & Schutze, 1999). By using the cosine measure, we followed established protocol: "two objects are similar if their corresponding vectors point in the same direction (i.e., they have roughly the same set of features and in the same proportion), regardless of their actual length" (Rasmussen & Karypis, 2004: 4). We used QDA Miner software from Provalis Research for the management of the qualitative manual coding of the BITs, and subsequent calculations of the cosine similarity measures.

Appendix 2 provides examples of BIT provision text for three countries included in the analysis. A less stringent BIT with the Netherlands would be the case of Turkey and a more stringent BIT would be the case of Costa Rica. In this example, the expropriation provision in Costa Rica's BIT includes stricter wording around payment for loss, referring to the need for a settlement date and interest.

Control variables. At the host-country level we used an indicator of rules that encourage FDI, cultural distance between home and host countries, host country market size and economic development as control variables. We also used a dichotomous dummy variable to capture whether the MNE had previously invested in the host country in a separate investment within the

time period under consideration. At firm level, we controlled for firm size and degree of internationalization. Given our data was pooled over time and involved MNEs from a variety of industries we also included year and industry dichotomous dummies (10 year dummies and 10 industry dummies). Table 2 shows all variables in terms of their definitions and measurement.

Table 2 about here

We employed a binary logistic regression to test our hypotheses. We treated the dataset as pooled cross-sectional as our theoretical focus is on examining the likelihood of MNE majority ownership as BIT stringency and political instability vary across countries, rather than over time. We note that the ratification year for the BITs used in our dataset ranged from 1964 to 2001, i.e., in time periods *before* the MNE investments. All variables were entered standardized and interaction terms calculated as the product of standardized variables. We ran robustness tests by replacing political instability with two other indicators of political uncertainty in the host country. These indicators included political constraints, or POLCON (Henisz, 2000) and economic freedom (Heritage Foundation, 2015). These are reported below.

4. Results

Table 3 shows the inter-correlations between variables of interest along with their descriptive statistics. Table 4 presents the results of the main binary logistic regression analysis. Multicollinearity is not a concern in this dataset. There are no extremely high inter-correlations between independent variables. Variance inflation factors (VIF) were below the cut-off of 10, further suggesting that multicollinearity does not interfere with the analysis (Neter, Wasserman, & Kutner, 1985: 392). The correlation matrix shows rules encouraging FDI to be negatively associated with majority ownership ($r=-0.16$, $p<0.01$). Rules encouraging FDI are negatively

associated with political instability ($r=-0.35$, $p<0.001$). As expected, cultural distance from the Netherlands correlates with country size, reflecting the investment interest in countries like China and Indonesia in our data ($r=0.12$, $p<0.05$), and GDP per capita correlates negatively with political instability ($r=-0.57$, $p<0.001$). BIT stringency has no significant correlation with majority ownership, whereas political instability is negatively correlated ($r=-0.10$, $p<0.1$).

Tables 3 and 4 about here

When entering the model alone, the effect of political instability is not significant (Table 4, Model 2). BIT stringency is also not significant (Model 3). The interaction effect in Model 4 shows that when political instability increases, highly stringent BITs act to reverse the MNE's preference for minority ownership and make it more likely the MNE will opt for majority ownership. At higher levels of political instability greater stringency of a BIT agreement will increase the likelihood that MNEs will choose a majority stake.

Table 5 shows additional robustness tests. In the first column we see the result when political instability is replaced by Henisz's political constraints measure (POLCON). We substituted our measure of political instability taken from the World Governance Indicators with an alternate operationalization of political constraints (Bergara, Henisz, & Spiller, 1998; Henisz, 2000; Henisz & Zelner, 2001). The political constraints (POLCON) index captures a different aspect of a country's level of political stability, i.e., the likelihood that it will undergo political change, by directly measuring the feasibility of a change in policy given the structure of a nation's political institutions (the number of veto points). It assesses the complex relationship between veto points and the degree of constraints on policy in the legislative and executive branches of government. Alignment across branches increases the feasibility of policy change

thereby reducing the level of political constraints and increasing the potential for a government turnover. Possible scores for the final measure of political constraints range from zero (most hazardous) to one (most constrained). We reversed this measure (i.e., 1-POLCON) to be consistent with our main test and expect a negative sign on the 1-POLCON coefficient as a direct effect and a positive sign for the interaction term. We ran an additional robustness test using economic freedom (reversed) (Heritage Foundation, 2015). The results are shown in Table 5. Figure 1 shows the effects of BIT stringency on the likelihood of MNEs' preferring majority ownership at various levels of political instability. Figures 2 and 3 show the interactions for POLCON (reversed) and economic freedom (reversed) respectively.

Table 5 about here

Figures 1-3 about here

5. Discussion

While previous scholarship has measured the impact of BITs through their presence - by using the *number* of these bilateral agreements in a particular time period or a dummy for BIT presence (Desbordes & Vicard, 2009; Elkins, Guzman, & Simmons, 2006; Jandhyala & Weiner, 2014; Neumayer & Spess, 2005; Rose-Ackerman & Tobin, 2005), we break new ground by introducing the construct of BIT stringency – a variable capturing differences in the design of BITs across the world. This is a more nuanced measurement than the simple presence (and count) of BITs and will allow researchers to open up new lines of enquiry into how international investment agreement *design* influences not only FDI flows, but also MNE strategy. While scholars have raised awareness of divergence in the content of BITs (Berger et al., 2010; Sachs

& Sauvant, 2009; Sornarajah, 2004), there has been a notable gap in research into how the design features of these agreements influence MNE strategy. Our study addresses this gap.

The present study draws attention to the important role played by the design features of international investment agreements in influencing MNE internationalization strategy. Prior research on MNE strategy has not accounted for these design features. Our specific focus has been on the stringency of BIT provisions and our empirical tests support the central argument that BIT stringency acts to moderate the relationship between political instability and subsidiary ownership choice in host countries. We find that a more stringent BIT will encourage the MNE to choose a majority ownership rather than a minority as political instability rises.

5.1 Theoretical implications

In terms of theory, our study highlights the multi-level nature of the investment environment that MNEs must consider while weighing the risks and potential benefits of different ownership arrangements under varying conditions of political instability. A stringent BIT is most effective at offering a credible commitment against expropriation and providing reassurance power that enables majority ownership by MNEs in host countries at higher levels of political instability. Our findings show that the *design* of a risk mitigation structure at an international level will influence how the firm views the potential impact of an unstable environment at a national level. We provide some support for scholars who have argued that investors do take BITs into account when preparing for investment in developing and emerging countries (Büthe & Milner, 2014; Sachs & Sauvant, 2009). We also provide support for recent advances in institutional theory indicating that events that occur within a nation-state's boundaries can be influenced by activities at other levels, including macro-levels (e.g., at the

global level) (De Villa, Rajwani, & Lawton, 2015; Scott, 2014). As Scott noted: “it is oversimplifying...to describe nation-states or organizations or their participants as if they were operating independently of institutional systems at other levels” (Scott: 2014: 105).

MNE internationalization is thus constrained by multi-level interactions between factors that either present or mitigate risk for MNE investors. This provides support to arguments in the tradition of institutional theory that a firm will make key strategic decisions in response to the characteristics of different layers of institutional arrangements in which the firm is embedded (De Villa, Rajwani, & Lawton, 2015; Scott, 2014). The origin and nature of rule emergence, and the environmental concern those rules seek to address together comprise a collective entity that determines MNE strategy and action. Strategic investment decisions by the MNE arise as a result of interactions between the nature of rule emergence at one level (BIT stringency) and a related environmental concern at another level (political instability). The impact of this interaction on MNE internationalization decisions illustrates the importance for theorists of avoiding treating any one type of external institution as a homogeneous whole, but more qualitatively as a nuanced set of design features.

5.2 Managerial and policy implications

Our study has a number of implications for MNE managers and government policy makers. The consistently significant interactions between BIT stringency and country level risk conditions show how both uncertainty in the policy environment and international investment agreements jointly matter when planning new entries abroad. The decision-making process inside the firm requires awareness of constraints and risk mitigation that emanate from *different institutional levels* in the external environment. MNE managers may not need to be too alarmed

by the prospect of higher levels of commitments in countries that have started to embark on a transition from a politically-unstable past. We think it is important that future work should investigate the performance consequences of the observed ownership choices in order to comment on performance-optimizing behavior under different levels of BIT stringency.

In terms of government policy, the findings indicate that host countries that are in an early stage of development and that seek inward FDI through foreign-majority-owned subsidiaries will achieve this by allowing for more stringent BITs with developed countries. Conversely, if the host country has already started a journey of improving political stability, it may not need to be too concerned about overly stringent BITs in order to provide reassurance for investors. The findings may also have broader implications for global trade and investment policy. Given that the number of disputes brought before arbitration has grown enormously in recent years – (Sachs & Sauvant (2009) reported that three quarters of all investor – state arbitration cases had occurred since 2002) – there is heightened sensitivity around stringency and arbitration. For example, the proposed Transatlantic Trade and Investment Partnership (TTIP) between the US and the EU faces criticism around Investor-State Dispute Settlement (ISDS) arbitration issues, including the criticism that too much protection (greater stringency) has been given to investors in the past, and less protection to host governments and other stakeholders in society. Given the enlarged EU also includes new accession states that are less developed than those in north and western Europe, negotiators may consider the stringency effect in the present study and argue that less stringency might actually be beneficial as uncertainty in such countries diminishes (Figures 1 – 3). This could diffuse some of the criticisms around the use of the ISDS system.

5.3 Limitations and research implications

The present study suffers from limitations in a number of areas. Firstly, the sample was taken from one developed country (The Netherlands) and from the investment activities of large MNEs listed on the stock exchange in that country. We caution against generalizing the implications of our study to MNEs originating in different types of markets (e.g., *from* developing countries) or to smaller internationalizing SMEs or born-globals. Future work can test the effect of design of IIAs on much broader samples. Secondly, our main dependent variable was ownership structure (majority vs. minority ownership) and not establishment mode choice (greenfield vs. acquisition). While it would be interesting in future work to examine the impact of BIT stringency on the greenfield vs. acquisition choice, it was not in the scope of our study to examine this. Further, we coded ownership as a dichotomous variable. Future work can look at the impact of BIT stringency on more fine-grained measurements of ownership such as the amount of capital invested and equity position (Tihanyi, Griffith, and Russell, 2005). Thirdly, a central theme in international business theory is the way MNEs learn and apply their experiences to their internationalization choices. We did not account for country-specific learning effects or firm-specific learning of the MNE through prior engagement in international arbitration or BIT ratification at a country level. How MNEs learn from and influence the design of provisions in international investment agreements could be examined in future work. Fourthly, our measure of BIT stringency was geared towards obligations related to expropriation risk. There may be other instances of international agreements and institutional arrangements in which qualitative design features may mitigate a broader range of investment risk. Fifthly, we did not differentiate between service vs. manufacturing firms in our sample. Recent research has shown that the relationship between BITs and FDI is stronger for investments in fixed capital than other

forms of MNE activity (Kerner and Lawrence, 2014) and this distinction could be examined further in future work on BIT stringency.

Finally, our study has implications for researchers investigating the drivers and consequences of MNE international strategy in a world of ever-changing institutions. The results suggest that researchers should pay close attention not only to the design of domestic but also to the design of IIAs when assessing MNE international strategies. Understanding the implications of political instability for MNEs cannot rely only on an assessment of domestic political environment unilaterally created in host countries. Domestic political environments should not be understood without including the international layer of analysis (De Villa, Rajwani, & Lawton, 2015; Scott, 2014), or as Keohane and Milner (1999) put it, without “comprehending the nature of the linkages between national economies and the world economy” (Keohane & Milner 1999: 3). Researchers might need to re-evaluate the importance of different types of distance measures in situations where the design of the wider institutional order holds greater relevance to MNE investments and the decision-making process behind these investments. These factors potentially are much more important when MNEs contemplate new investments in countries where national governments have decided to participate in the design of international agreements in a way that addresses the concerns of investors under adverse political conditions. We encourage future researchers in the field of MNE strategy to pay more attention to the design of international investment agreements between home and host countries.

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Table 1

Sampled countries grouped by World Bank Governance Indicators political stability percentile rank

< 10	>=10, < 30	>=30, < 50	>=50, < 60	>= 60
Ethiopia Nigeria Philippines	Ecuador Egypt India Indonesia Kenya Peru Russia Thailand Turkey Venezuela	Argentina China Mexico South Africa Ukraine	Bulgaria Malaysia Mongolia Poland Romania Tunisia Vietnam	Belarus Costa Rica Czech Republic Estonia Hungary Singapore South Korea Slovakia Taiwan

Table 2

Data variables, measurements, definitions and sources.

Variable / Type	Measurement	Definition	Source
Subsidiary Ownership Choice / Dependent	1 = majority; 0 = minority	Parent firm's ownership arrangement in foreign direct investment: majority = $\geq 51\%$; minority = $< 51\%$	AEX-listed MNE annual reports. 2004-2013
BIT stringency /Independent	Cosine similarity between BIT ratified between the Netherlands and host country and a benchmark BIT	The stringency of the BIT between the two countries under which the investment is made	(See Appendix 1)
Political instability/Independent	Scale from -2.5 to +2.5 (inverted); higher scores = relatively higher political instability	The likelihood that a government will not be destabilized or overthrown by unconstitutional means, including political violence or terrorism	<i>World Governance Indicators</i> (The World Bank) http://info.worldbank.org/governance/wgi/resources.htm
FDI rules/Control	Item 6.12 in the <i>GCR</i> ; scores from 1 to 7 with higher values = pro-FDI laws	Business impact rules on FDI: The degree to which host countries legislate rules that foster foreign direct investment	<i>Global Competitiveness Report</i> (World Economic Forum)
Cultural distance/Control	Summed squares of the variance between host country and The Netherlands	National cultural differences between a home & host country based on four dimensions	Hofstede (1980); Kogut & Singh (1988)
GDP per capita/Control	Log of gross domestic product/population	Economic development of host country	Economist World in Figures, 2006; World Bank Data 2006 (http://data.worldbank.org/indicator/)
Population/Control	Log of host country population	The size of the host country's market in term of its population	Thomson DataStream; World Bank Data (http://data.worldbank.org/indicator/)
MNE size/Control	Log of total number of parent firm's employees	Parent firm's size in terms of its worldwide employee base	AEX-listed MNE annual reports.
Internationalization/Control	Parent firm's foreign sales as a % of total sales	The degree to which the parent firm has a presence in international markets	AEX-listed MNE annual reports.
Host experience / control	1 = prior investment in country; 0 = no prior investment in country	Dichotomous variable indicating whether MNE has prior investment in the host country within period under study	AEX-listed MNE annual reports.

Table 3
Correlations and descriptive statistics.

	1	2	3	4	5	6	7	8	9	10
Ownership 1	1									
BIT stringency 2	-0.04	1								
Political instability 3	-0.10+	0.07	1							
FDI rules 4	-0.16**	-0.07	-0.35***	1						
Cultural distance 5	0.05	-0.19***	-0.14*	0.11+	1					
GDP per capita (ln) 6	0.15*	-0.18**	-0.57***	-0.21***	-0.02	1				
Population (ln) 7	-0.18**	0.03	0.37***	0.28***	0.12*	-0.47***	1			
MNE size (ln) 8	-0.05	0.17**	0.08	-0.04	0.02	-0.14*	0.00	1		
Internationalization 9	0.10+	-0.02	-0.08	0.13*	0.13*	-0.05	0.11+	0.10+	1	
Host experience 10	0.03	-0.14*	0.05	0.16**	-0.02	-0.13*	0.26***	0.07	0.02	
Mean	0.64	0.59	0.45	4.97	4.41	8.12	11.78	10.64	61.65	0.47
Std. Dev.	0.48	0.02	0.74	0.74	1.75	1.01	1.83	1.66	21.84	0.50

+p<0.1, * p< 0.05, ** p< 0.01, *** p< 0.001.

Table 4

Logistic regression results – political instability.

	Model 1	Model 2	Model 3	Model 4
FDI rules	-0.43**	-0.57**	-0.43**	-0.66**
	(0.17)	(0.23)	(0.17)	(0.26)
Cultural distance	0.28+	0.26	0.26	0.14
	(0.17)	(0.17)	(0.17)	(0.20)
GDP per capita (log)	0.01	-0.14	-0.01	-0.15
	(0.19)	(0.25)	(0.19)	(0.27)
Population (log)	-0.58**	-0.51**	-0.58**	-0.81***
	(0.21)	(0.22)	(0.21)	(0.25)
MNE size (log)	0.09	-0.09	0.10	0.05
	(0.27)	(0.27)	(0.27)	(0.28)
Internationalization	-0.20	-0.21	-0.20	-0.25
	(0.19)	(0.19)	(0.19)	(0.20)
Prior host experience	0.34	0.32	0.33	0.58
	(0.36)	(0.36)	(0.36)	(0.39)
Political instability (PI)		-0.26		-0.36
		(0.28)		(0.30)
BIT stringency (BITSTR)			-0.05	-0.40+
			(0.15)	(0.21)
PI x BITSTR				0.81***
				(0.25)
Year dummies included	Yes	Yes	Yes	Yes
Industry dummies included	Yes	Yes	Yes	Yes
-2 log likelihood	294.74	293.86	294.62	277.94
Pseudo R2	0.25	0.25	0.25	0.29

Robust standard errors are in parentheses.

All independent and control variables are standardized.

20 dummy control variables for year and industry included but not shown.

N=289

+p<0.1, * p< 0.05, ** p< 0.01, *** p< 0.001.

Table 5

Logistic regression results – additional tests.

	1- POLCON (DV=Maj. Control)	1- POLCON (DV=Maj. Control)	Economic Freedom (reversed) (DV=Maj. Control)	Economic Freedom (reversed) (DV=Maj. Control)
Cultural distance	0.33*	0.40+	0.22	0.34
	(0.20)	(0.21)	(0.17)	(0.23)
GDP per capita (log)	0.18	0.1	0.28	0.47*
	(0.19)	(0.19)	(0.19)	(0.21)
Population (log)	-0.23	-0.11	-0.90***	-1.14***
	(0.24)	(0.25)	(0.25)	(0.29)
MNE size (log)	0.05	0.08	0.11	0.01
	(0.27)	(0.27)	(0.27)	(0.28)
Internationalization	-0.27	-0.25	-0.19	-0.19
	(0.19)	(0.19)	(0.19)	(0.20)
Prior host experience	0.21	0.33	0.31	0.67
	(0.36)	(0.37)	(0.36)	(0.39)+
<i>Independent variable (IV)</i> <i>(see column header)</i>	-0.59**	-0.65**	0.71**	0.90**
	(0.22)	(0.22)	(0.29)	(0.33)
BIT stringency (BITSTR)	-0.20	-0.07	0.05	0.15
	(0.17)	(0.18)	(0.16)	(0.17)
<i>IV x BITSTR</i>		0.42+		1.31***
		(0.23)		(0.29)
Year dummies included	Yes	Yes	Yes	Yes
Industry dummies included	Yes	Yes	Yes	Yes
constant	1.84	1.91	0.87***	1.79
-2 log likelihood	297.14	293.69	235.40	273.65
Pseudo R2	0.25	0.25	0.24	0.30

Robust standard errors are in parentheses.

All independent and control variables are standardized.

20 dummy control variables for year and industry included but not shown.

N=289

+p<0.1, * p< 0.05, ** p< 0.01, *** p< 0.001.

FIGURES

Fig 1. Moderating Effect of BIT Stringency on the Relationship between Political Instability and Ownership

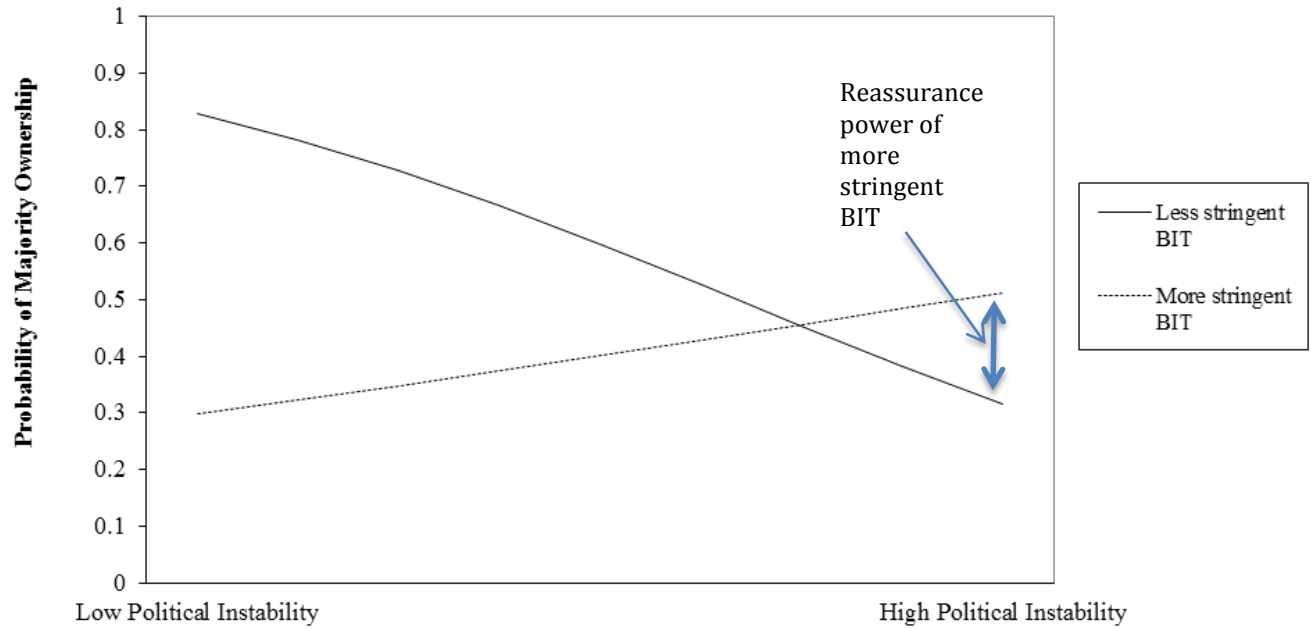


Fig 2. Moderating Effect of BIT Stringency on the Relationship between Policy Uncertainty and Ownership

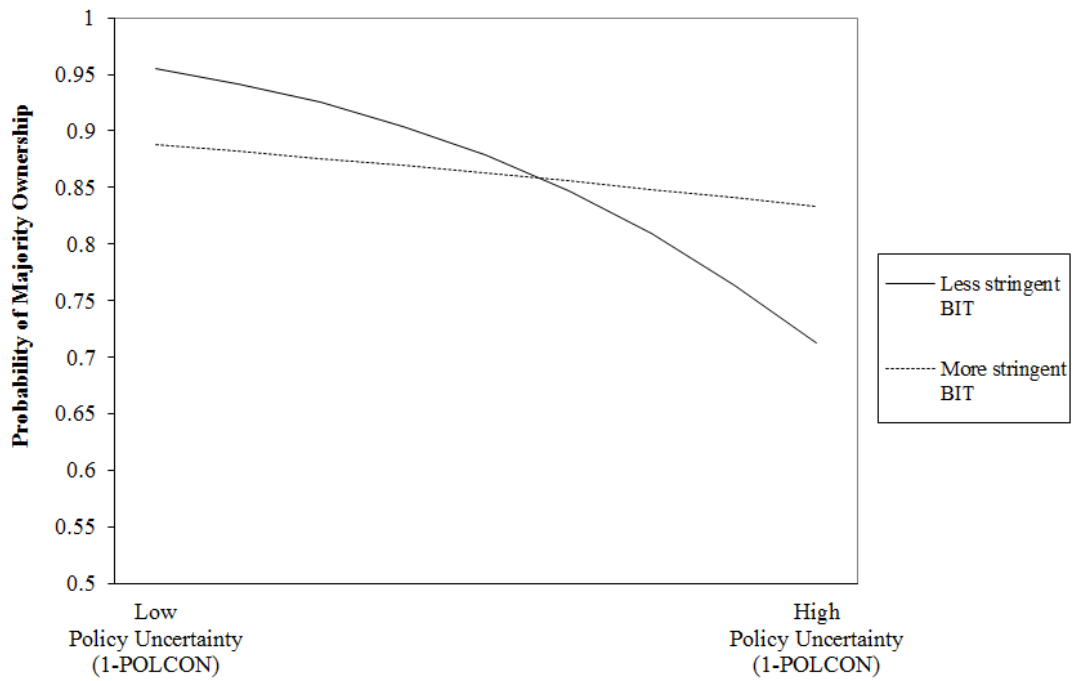
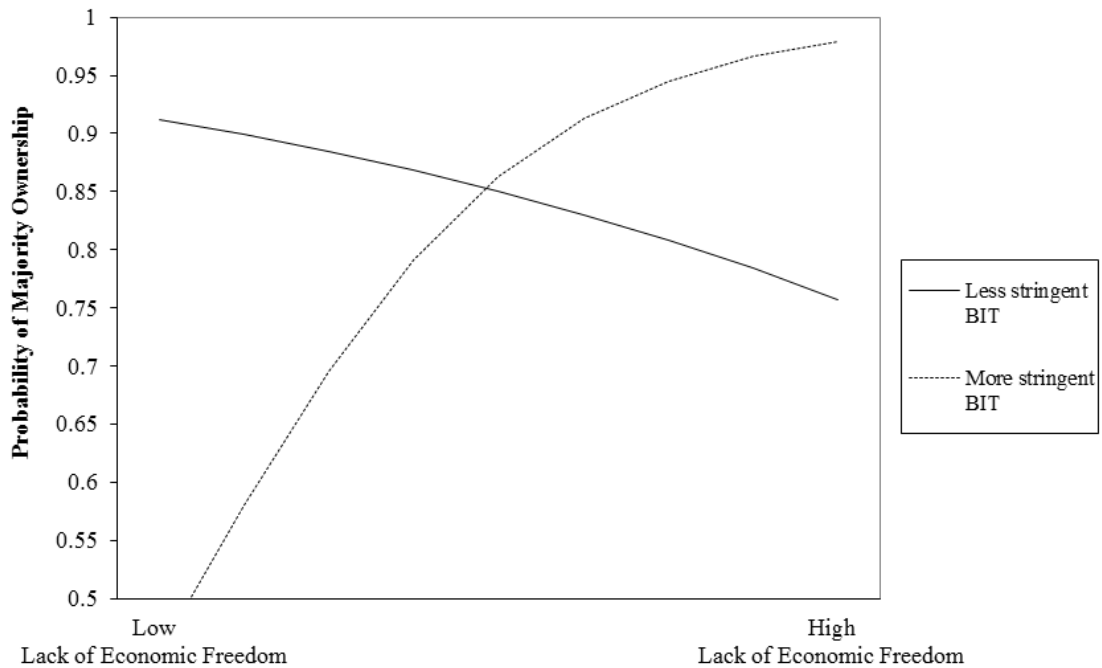


Fig 3. Moderating Effect of BIT Stringency on the Relationship between Lack of Economic Freedom and Ownership



Appendix 1

Construction of BIT Stringency Measure

A Bilateral Investment Treaty (BIT) is the most common form of an International Investment Agreement (IIA) between two countries. A BIT is a legal text document that consists of several articles (a primary division of any legal document) and each article typically covers a particular issue. Topics concerning expropriation and the written safeguards against potential expropriation of assets by a national government tend to be included in a BIT article. This expropriation article covers several obligations, such as the type of expropriation, conditions for expropriation, types of compensation for expropriation, timing of expropriation, dispute settlement procedures, and sometimes treatment of foreign investors during the expropriation process. BITs expropriation articles differ in the number of obligations they contain as well as in the content of each obligation.

What we call “BIT stringency” refers to the degree of legal protection against expropriation specifically expressed in a BIT articles. The more protection that is stipulated in the BIT article, the tighter or higher the BIT stringency. The basis for the new measure of BIT stringency is a systematic manual analysis of the content of BIT articles dealing with protection of foreign investors against expropriation in host states in the 915 English-language BITs that became effective between 1962-2007.

Building the quantitative dataset from the qualitative textual information involves identification of the patterns of similarities and differences of the compared texts, text units. Accomplishing this task of pattern identification in BITs’ expropriation articles requires identification of specific legal obligations and rights of host states and foreign investors before, during, and after proscribed expropriations. Each BIT obligation usually has an identifying key word or phrase which is often a specific legal term. Since legally binding international documents use extreme caution in choosing the appropriate words and phrases, one key word or phrase corresponds to a BIT design feature. Thus, these key phrases for obligations are the basis for the classification of BITs’ expropriation provisions into separate categories, each of which represents a distinguishable design feature.

To calculate the BIT stringency as a cosine similarity measure, we undertake several steps. **First**, we identify a benchmark of all existing English-language BITs using as a reference those specific provisions in the articles of BITs that maximally protect foreign investors from expropriatory actions of host states. These provisions constitute the “ideal” or benchmark BIT. **Second**, each Netherlands BIT is represented as an n-dimensional vector with coordinates taking a value of 0 or 1 depending on whether a specific protective provision is present or not in the BIT agreement between the dyad of The Netherlands and another country. The cosine coefficient measures the cosine of the angle between two n-dimensional vectors. One vector, a mathematical representation of an “ideal” BIT, which has all provisions that could maximally protect FDI, has all 1s for each dimension-provision protecting FDI. Another vector has 0s or 1s depending on whether the corresponding Netherlands BIT includes the provision protecting FDI against potential expropriation not. Thus, each BIT dyad (between The Netherlands and another country) becomes an n-dimensional vector reflecting whether protective “ideal” provisions are present or not. A score that approaches one has relatively more safeguards against potential expropriatory actions. The more protective provisions a Netherlands/other country BIT has, the greater its similarity to the “ideal” BIT.

Appendix 2
Examples of BIT provisions

<i>Country with ratified BIT with the Netherlands</i>	<i>BIT stringency coefficient</i>	<i>Provisions</i>
Turkey, in force since 1989	0.559 Interpreted as a 'Less Stringent BIT'	Expropriation (Article 5): “Neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments unless the following conditions are complied with: (a) the measures are taken in the public interest and under due process of law; (b) the measures are not discriminatory; (c) the measures are accompanied by provision for the payment of just compensation. Such compensation shall amount to the fair market value of the investment or in the absence of a fair market value the genuine value of the investments affected and shall, in order to be effective for the investors, be paid and made freely transferable, without unreasonable delay, to the country of which the investors concerned are nationals or to any other country accepted by the Contracting Party concerned and in the currency in which the investment was originally made or in any freely convertible currency, mutually agreed to by the investor and the Contracting Party.”
Philippines, in force since 1987	0.618 Interpreted as a 'Medium Stringent BIT'	Expropriation (Article 5): “Investments or earnings of nationals of either Contracting Party shall not be subject to expropriation or nationalization or any measure equivalent thereto in this article, all such measures are hereafter referred to as ‘expropriation’, except for public use, in the public interest, or in the interest of national defence and upon payment of just compensation. Such compensation shall amount to the market value of the investment expropriated, or, in the absence of a determinable market value, the actual loss sustained, on or immediately before the date of expropriation. The compensation shall be made without undue delay, shall be effectively realizable and, subject to the provision of paragraph 3, Article 7, shall be freely transferable in a freely convertible currency to the country designated by the national affected. The national affected shall have a right, under the law of the Contracting Party making the expropriation, to prompt review by a judicial body, or, if such exists, by another independent authority of the Party of his case and of the valuation of his investment in accordance with the principles set out in this paragraph.”

<p>Costa Rica, in force since 2001</p>	<p>0.637</p> <p>Interpreted as a 'More Stringent BIT'</p>	<p>Expropriation (Article 6):</p> <p>“1.- Neither Contracting Party will undertake, directly or indirectly, measures of nationalization or expropriation, nor any other measure having an equivalent effect, against investments of investors of the other Contracting Party, except in cases when any of such measures have been adopted for a public purpose, on a non-discriminatory basis, under due process of law, and against prompt, adequate and effective compensation.</p> <p>2.- The compensation shall be paid promptly, it shall amount to the fair market value of the investment expropriated immediately before expropriation or impending expropriation became public knowledge, and it shall be effectively realizable and be freely transferable. The amount of such compensation shall include interest from the date of dispossession of the expropriated property until the date of payment, according to a normal commercial rate for the currency in which it will be paid.”</p>