

HOST GOVERNMENT INTERVENTION AND FDI INFLOW: AN EMPIRICAL INVESTIGATION

ABSTRACT

We examine the effect of host government interference in Multinational Firms' (MNEs) operations on Foreign Direct Investment (FDI) inflow. We test our hypothesis using data from the International Centre for the Settlement of Investment Disputes (ICSID) between 1996 and 2017. The results show that the relationship between host government interference and FDI inflow takes the form of an Inverted-U shape. While a few interferences do not deter FDI decisions, frequent interference by host governments nudges MNEs to reduce their investments in a host country. The findings suggest that countries seeking to attract more FDI should settle investor-related disputes at home, not in international arbitration courts, because doing so frequently may deter MNEs from investing in their territory.

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INTRODUCTION

How does host government interference in Multinational Firms' (MNEs) operations affect the attractiveness of a host country as a destination for Foreign Direct Investment (FDI)? Do host governments that often interfere in foreign investors' private property right receive less FDI than their peers? MNEs host country relationships have been at the core of International Business (IB) research since its early years. From classic transaction cost theorists (Teece, 1986; Williamson, 1967) to the obsolescing bargaining literature (Ramamurti, 2001; Vernon, 1971), all have recognized the potential costs that host governments can impose on MNEs. The most severe breakdown an MNE can experience is in its relations with host governments because it can lead to expropriation of assets or profits by host governments (Duanmu, 2014; Medina, Bucheli, & Kim, 2019). Such actions can significantly affect MNEs' performance because revenues lost due to host government interference in the form of expropriation of assets and profits can run into billions of dollars. Understandably, MNEs are very sensitive to the threat of host government interference, understood as acts stemming from host governments that are designed to precipitate a change in the behavior of MNEs in a direction compatible with host government objectives (Kobrin, 1984; 1980; Makhija, 1993). As such, the management of host country relationships has become a particularly important function within MNEs (Makhija, 1993; Stevens, Xie, & Peng, 2016).

There is anecdotal evidence that host governments that interfere in MNEs operations poison the investment climate of their country and hence will get less FDI. Host governments, particularly from developing countries are advised not to interfere in the operations of foreign firms operating in their territories (UNCTAD, 2018) because MNEs only invest and stay in host countries where they are treated well. In order to attract more FDI and the related spillovers to

their economies, many governments invest time and other scarce resources to negotiate, conclude, sign and ratify International Investment Agreements (IIAs) to alleviate foreign investors' concerns (Büthe & Milner, 2008; Elkins, Guzman, & Simmons, 2006; Neumayer & Spess, 2005). MNEs rely on these IIAs as a mechanism for safeguarding their investments (Allee & Peinhardt, 2011; 2010; Jandhyala & Weiner, 2014). Typically, IIAs include provisions of national treatment, most favored nations, and the possibility to repatriate profits as well as appropriate compensation in the event of expropriation. Most importantly, they also include provisions that permit aggrieved MNEs to challenge host government policies that violate the IIAs commitments via international arbitration, i.e., Host Country Dispute Settlements (HCDS) (Allee & Peinhardt, 2011; 2010; Dolzer & Schreuer, 2012). Although investment arbitration has proven to be an effective means of deterring host government from arbitral interference with foreign firms' assets (Jandhyala & Weiner, 2014), evidence in recent years shows that host governments are increasingly interfering in MNEs operations, and in some cases expropriating their assets. This has led to an increasing number of MNE-host government confrontations. As shown in figure 1, since the early 1970s, the number of MNE host government disputes settled at the International Center for the Settlement of Investment Disputes (ICSID) has increased markedly, reflecting the increasing number of investment treaties in existence.

**** insert figure 1 around here****

Interestingly, although MNEs rely on IIAs to protect their investments and profits in foreign countries, and even invest more in countries where there are IIAs (Albino-Pimentel, Dussauge, & Shaver, 2018; Neumayer & Spess, 2005), the strategy, and international business literature, which by nature study firm-level decisions, have paid very little attention to host country dispute settlements (HCDS). This study seeks to fill this gap. We use data from International Centre for the Settlement of Investment Disputes (ICSID), the international arbitration institution established by the United Nations under the World Bank in 1966 for legal dispute resolution and conciliation

between foreign investors and host countries to examine the effect of HCDS on FDI inflows. We find that the relationship between host government interference and FDI inflow takes the form of an Inverted-U shaped curve. Initial and few interferences do not deter FDI; however, as the number of interferences increases, MNEs begin to reduce investment levels in a destination country. It seems that when faced with environmental uncertainties originating from host government actions, MNEs adopt a wait and see strategy; however, how long they wait depends on the economic situation of the host country. For high-income countries, MNEs wait until approximately ten interferences before exiting a host country, while for low-income countries, this waiting period is merely two interferences.

Overall, this article makes three contributions. First, while earlier studies focus on the *ex-ante* effect of IIAs on FDI inflow (Albino-Pimentel, Dussauge, & Shaver, 2018; Jandhyala & Weiner, 2014; Neumayer & Spess, 2005), we highlight the effect of host governments *ex-post* behavior on FDI inflow. IIAs enhance host countries' credibility because noncompliance is enforceable by MNEs through international arbitration and may require host governments to pay compensation to MNEs. Thus, knowing that they can punish poor behavior, MNEs invest more in countries with IIAs. However, this *ex-ante* account of the effect of IIAs hinges on the assumption that signatory host governments will not renege on their IIA commitments in the future (Allee & Peinhardt, 2011). Nevertheless, as evidenced in figure 1, and Table 2, many host governments take *ex-post* actions that harm MNEs and contravene their IIA obligations. We enrich the political risk and international business literature by examining the effect of such *ex-post* behavior on FDI inflow. Second, contrary to earlier studies that focus on the role of host country domestic institutions (Khanna & Palepu, 1997; Meyer, Estrin, Bhaumik, & Peng, 2009; North, 1990; Peng & Heath, 1996), we highlight the role of international institutions on FDI inflow. IB research on international institutions tend to focus on issues such as corruption mitigations (Cuervo-Cazurra & Genc, 2008; Rodriguez, Uhlenbruck, & Eden, 2005) and coercive pressure of transnational

agencies (Henisz, Zelner, & Guillén, 2005). We broaden the discussion by examining MNEs host country confrontations, responding to Sun, Mellahi, and Thun (2010) call for more exploration into how firms “how firms mitigate potential rent misappropriation.” Finally, by considering MNEs host government disputes globally, we extend the geographic reach of the empirical research on FDI inflow. Earlier studies of FDI inflow have concentrated on single countries (Hymer, 1960/1976; Loree & Guisinger, 1995; Nigh, 1985) or a few medium to high-income countries (Habib & Zurawicki, 2002; Olibe & Crumbley, 1997). Never before has the inflow of FDI in all regions across the world been systematically studied via a common research design and methodological instrument as we have done in this study.

THEORY AND HYPOTHESIS

HOST GOVERNMENT INTERFERENCE IN FOREIGN FIRMS’ OPERATIONS

Host government interference in MNEs' operations was at the center of the scholarly debates during the 1960s and 1970s, when many developing countries expropriated foreign MNEs' assets, particularly in the natural resources and extractive sectors (Fagre & Wells, 1982; Kobrin, 1984; 1979). By the late 1980s and early 1990s, many countries seeking to attract more FDI adopted MNE-friendly policies (Grosse, 2007; Minor, 1994), leading some scholars to argue that host government interference has lost its relevance in the contemporary global economy (Li, 2009; Minor, 1994).

In the strategy and international business literature, host government interference has been defined as any involuntary action that reduces the economic values of a firm's assets or profits (Kobrin, 1984; 1980). Host government interference may be direct or indirect. While direct interference arises from outright nationalization or transfer of assets (i.e., direct interference), indirect interference (i.e. “de facto”, “disguised”, “constructive”, or “creeping” interference) occurs when a host government takes effective control of or otherwise interferes with foreigners’

investments that depreciate its economic value. It includes formal takings sanctioned by parliament or the executive branch of government, extra-legal interventions or the lack thereof, forced sales of equity, and divestment resulting from the renegotiation of contracts, etc. Thus, host government interferences are any form of host government unilateral actions that are official in nature and require a certain level of compliance by MNEs. If such interference negatively affects the economic value of MNEs' assets, the firm can rely on the host governments IIA commitments and initiate a legal dispute resolution process in the form of international arbitration (Dolzer & Schreuer, 2012; Kobrin, 1984; 1980; Newcombe, 1999).

IAs are the primary international vehicle by which FDI is regulated (Allee & Peinhardt, 2011). They are legally binding supranational arrangements signed between countries to govern and stimulate investments (Rangan & Sengul, 2009). There are two types of IIA treaties: Bilateral Investment Treaties (BITs) and Multilateral Investment Treaties (MITs). BITs are investment agreements between two countries. An example of a BIT is the Ghana-Switzerland BIT of 1991. MITs are investment agreements between several countries. An example of MIT is the 1994 North American Free Trade Agreement (NAFTA) between Canada, the United States, and Mexico. Today, there are over 3000 active IAs globally (UNCTAD, 2017). While countries sign IAs to attract more FDI (Büthe & Milner, 2009), MNEs rely on IAs to protect their investments (Allee & Peinhardt, 2011; 2010). By signing and rectifying IAs, host governments reassure fearful MNEs that they are truly committed to refrain from interfering with their operations. Host governments that violate IIA commitments and are challenged by MNEs through international arbitration suffer direct financial costs of contesting the litigation, reputation cost associated with being a defendant, and the payment of a potential sizeable arbitration award (Dolzer & Schreuer, 2012; Salacuse & Sullivan, 2005). As a result, some scholars (Allee & Peinhardt, 2011; 2010) have argued that investments in host countries with IAs are less likely to be interfered with, but, as figure 1 shows, host government interference is widespread.

THE INTERNATIONAL INVESTMENT DISPUTE SETTLEMENT PROCESS

MNEs vary in their response to host government interference as a result of differences in their organizational capabilities (Holburn & Zelner, 2010), and the relationship between their home and host countries (Wellhausen, 2015). Traditionally, MNEs have responded to host government interference by either doing nothing (or waiting to see), de-internationalizing from the host country (Benito & Welch, 1997; Dai, Eden, & Beamish, 2017), or by challenging the host government's decision in international arbitration courts, i.e. host country dispute settlement (HCDS). Should MNEs decide to challenge a host government's noncompliance with IIA commitments by way of HCDS, the dispute settlement process begins with the aggrieved MNE submitting a request for consultations with the host government¹. If the dispute is not settled after consultations, unlike local firms, MNEs have the option to pursue international arbitration at a destination such as ICSID. All MNEs whose home country has IIA with the host country can initiate HCDS proceedings (Dolzer & Schreuer, 2012). This possibility to settle disputes in international arbitration courts affect MNEs further investment decision in the host country (Albino-Pimentel, Dussauge, & Shaver, 2018; Jandhyala & Weiner, 2014).

THE EFFECT OF HOST GOVERNMENT INTERFERENCE ON FDI DECISIONS

Previous studies have analyzed the political and economic factors that prompt host government interference. According to the classic obsolescing bargaining logic, after an MNE has invested in a country, it loses bargaining power with the host government, and the MNE becomes subject to policy changes and increasing interference with their operations (Fagre & Wells, 1982; Vernon,

¹ See Article 14 of Norway's model bilateral investment treaty (BIT) for example how IAs regulate dispute settlement between MNEs and host governments. Available at <https://www.regjeringen.no/contentassets/e47326b61f424d4c9c3d470896492623/draft-model-agreement-english.pdf> retrieved 02.05.2019.

1971). Nathan and Leonard (2004) find that governments that depend more on natural resources for their economy are more likely to interfere in MNEs' operations. Similarly, Kobrin (1980) finds that MNE-specific factors such as the sector of investment and the percentage owned by the parent company also influence the likelihood of host government interference. On the form of governance, Henisz (2000) and Jensen (2003) find that both liberal democracies and non-democracies interfere in MNEs operations; however, interference is more likely to occur in non-democratic countries. Host governments interfere in MNEs operations because it benefits them (Henisz, 2000). Host governments can transfer revenue from the MNE to the state budget or by transferring MNEs assets or property rights to domestic ownership, as a result, host governments do not interfere in the operations of all MNEs in an industry, rather they do so selectively (Boddewyn, 2005; Kobrin, 1984).

In general, MNEs prefer host governments to be credibly committed to a set of policies and rules because that makes them predictable and reduces the risk of interference, as such MNEs prefer to invest in such countries (Henisz, 2000; Murtha & Lenway, 1994). However, several studies in recent years suggest that some firms may prefer investing in riskier countries (Heidenreich, Mohr, & Puck, 2015; Holburn & Zelner, 2010). Supportive of this view is that MNEs vary in their response to host government interference and host country risk because of differences in organizational capabilities for assessing and managing risks (Albino-Pimentel, Dussauge, & Shaver, 2018; Dorobantu, Kaul, & Zelner, 2017). According to García-Canal and Guillén (2008), some MNEs find it more attractive to invest in high-risk countries where governments have discretionary policymaking capacities because the firm, relying on its capabilities, can negotiate favorable conditions of entry and operations. That is, MNEs seek investment strategies conducive to superior performance, taking into account host country risk as well as the firm's capabilities. In assessing risk versus return, a specialized branch of literature on international investment decisions known as the hysteresis hypothesis shows that when faced with

host country uncertainty the best strategy is to wait and see (Baldwin & Krugman, 1989; Dixit, 1989; 1992). According to the hysteresis theory, defined as the failure of an effect to reverse itself as its underlying cause is reversed (Baldwin & Krugman, 1989; Dixit, 1989; 1992), an MNE that entered a foreign market when local currency appreciated will not immediately exit when the local currency depreciates. The firm will “wait and see.” Integrating these arguments from a traditional economic efficiency standpoint we argue that host government interference and the associated increased in host country risk may not immediately deter FDI from a country, however, over time as the number of interferences increases, MNEs may reduce investments level in that host country. That is, in the event of host government interference, first the country’s FDI inflow increases with times but at a decreasing rate to reach a maximum, after which it decreases at an increasing rate. Therefore, we expect the relationship between host government interference and FDI inflows to be an inverted parabola. We put forth the following baseline hypothesis:

***Hypothesis:** There is an inverted U-shaped relationship between host government interference and FDI inflow.*

EMPIRICS

DEPENDENT VARIABLE

Our main dependent variable is FDI inflow. Consistent with previous studies (Globerman & Shapiro, 2003; Kimino, Saal, & Driffield, 2007; Li & Vashchilko, 2010; Neumayer & Spess, 2005), we collected FDI inflow data from UNCTAD's Foreign Direct Investment Statistics for the period 1996–2017. We use the absolute FDI inflow into the studied countries as the main dependent variable, because if we were to use FDI inflow as a percentage of host countries GDP for instance, the measure would capture changes in the relative importance of FDI to the host country but not changes in inflows directly (Neumayer & Spess, 2005).

According to an exclusive report by The Economist (2013), the world has 50 -60 tax havens serving as a domicile for more than 2 million paper companies. It is estimated that between 10 and 30 percent of global FDI is channeled through tax havens (Haberly & Wójcik, 2014). As some scholars have already acknowledged (Beugelsdijk, Hennart, Slangen, & Smeets, 2010), countries that position themselves as tax havens receive large FDI inflows, but these FDIs do not necessarily generate value-adding activities in the focal country. MNEs send a large amount of FDI to tax havens countries to avoid paying taxes on them (Hines & Rice, 1994; Lipsey, 2007). To control for the use of holding companies and chains ownership to reduce tax burdens on firms without necessarily generating value-adding activities in the focal country, we dropped tax haven countries from the dataset. Consistent with previous studies (Akamah, Hope, & Thomas, 2018), we rely on the definition of tax havens provided by Dyreng and Lindsey (2009)². Our overall sample contained data on 142 countries for a period of 22 years, from 1996 - 2017. Table 1 provides detailed information on the variables we used in this study as well as their sources.

**** insert table 1 around here****

INDEPENDENT VARIABLE – ICSID AS A SOURCE OF HOST GOVERNMENT INTERFERENCE

Our main independent variable is the existence of MNE host country dispute settlement (HCDS) proceedings at an international arbitration tribunal. We used international arbitration data because arbitration is the last resort remedy for foreign firms in case of host government interference in their operations (Dolzer & Schreuer, 2012). We collected HCDS data from the United Nations Conference on Trade and Development (UNCTAD) investment policy database (<https://investmentpolicyhub.unctad.org/ISDS>). The investment policy database is a

² We dropped Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Belize, Bermuda, British Virgin Islands, Brunei, Cape Verde, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Dominica, Gibraltar, Grenada, Guernsey and Alderney, Hong Kong, Ireland, Isle of Man, Jersey, Kitts and Nevis, Latvia, Lebanon, Liberia, Liechtenstein, Luxembourg, Macau, Maldives, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Netherlands Antilles (or Dutch Antilles), Niue, Palau, Panama, Samoa, San Marino, Seychelles, Singapore, St. Lucia, St. Vincent and The Grenadines, Switzerland, US Virgin Islands, Uruguay, and Vanuatu from the dataset.

comprehensive database that contains HCDS cases decided under ICSID and the International Chamber of Commerce (ICC) (UNCTAD, 2017). It contains extensive information on HCDS with specific dates of initiation, names of the respondent country as well the BIT or MIT upon which the dispute settlement is initiated. We used the respondent country as the identifier of the focal state. IIAs typically specify multiple venues through which aggrieved MNEs or host governments may pursue their grievances (Dolzer & Schreuer, 2012). However, studies show that ICSID is the most important and most used arbitral venue. ICSID is used far more than all other options combined (Allee & Peinhardt, 2010). MNEs have turned to ICSID to contest host governments' interference eight times as frequent as they turn to all other institutionalized arbitration bodies due to its establishment by international convention in 1966 and close ties with the World Bank (Allee & Peinhardt, 2011). ICSID's functioning is aided by a secretary-general empowered to disregard frivolous cases. That is, only legally valid claims are permitted by the secretary-general to proceed to arbitrators. Its rulings are legally binding on the parties and in domestic courts of all ICSID member states. Today, ICSID has 161 signatory member countries, making the enforcement of ICSID ruling almost universal. Between 1996 and 2017, there were a total of 904 known treaty-based HCDS. 580 were concluded, 314 were pending, and 10 had an unknown outcome. Argentina had the most lawsuits with 60 registered cases. This was followed by Venezuela, Spain and the Czech Republic, with 44, 43 and 35 cases respectively. Table 2 provides an overview of the countries with the most number of investor arbitration cases.

**** insert Table 2 around here****

CONTROL VARIABLES

We added several control variables that have been found to be of importance in previous studies of host country determinants of FDI inflows (see Chakrabarti (2001) or Blonigen (2005) for a review). The main control variables are institutions, GDP per capita, market size, inflation, natural resource endowment, and political uncertainties.

Institutions. The institutional fabric of a host country influences the willingness of foreign firms to invest in it (Aguilera & Grøgaard, 2019; Meyer, Estrin, Bhaumik, & Peng, 2009). Following previous studies (Chen, Cui, Li, & Rolfe, 2017; Meyer, Estrin, Bhaumik, & Peng, 2009), we control for the development of institutions in a host country. We collected institutional data from the World Bank worldwide governance indicators (Kaufmann, Kraay, & Mastruzzi, 2011). This database consists of six aggregate indicators based on a compilation of cross-country data on governance. Our theoretical consideration suggests that our concept of institution focuses on institutions that support foreign firms to access fair treatment in a host country. In line with previous studies (Chen, Cui, Li, & Rolfe, 2017; Meyer, Estrin, Bhaumik, & Peng, 2009) we used the average of *rule of law*, *regulatory quality*, and *government effectiveness* indices as a proxy for market supporting institutions in a host country. Rule of law measures the extent to which agents have confidence in and abide by the rules of society, particularly the quality of contract enforcement, property rights, the police, and the courts. Regulatory quality captures a host government's ability to formulate and implement sound policies and regulations that permit and promote private sector development. Government effectiveness measure the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (Kaufmann, Kraay, & Mastruzzi, 2011). The World Bank indicators are available as time series, which allow us to assign each observation the value pertaining to the year of FDI entry.

Market size, GDP per Capita, inflations. Consistent with previous studies on FDI inflows (Büthe & Milner, 2008; Dunning, 1998), we control for host country-specific demographic as well as economic factors. We control for market size of the host country GDP per capita as well as inflation levels. Population was used as a proxy for market size.

Natural resource intensity. We employ a measure of natural resource intensity to control for the fact that, all other things being equal, host countries with large natural resources are more likely to attract more FDI (Dunning, 1988; Ramasamy, Yeung, & Laforet, 2012). We adopted a

measure equal to the sum of natural resource rent as a percentage of GDP for each country, as reported by the World Bank (2019) for this study.

Investment Treaties. Several studies have shown that investment treaties influence the location choice of MNEs (Albino-Pimentel, Dussauge, & Shaver, 2018; Neumayer & Spess, 2005). Countries that sign investment treaties are more likely to receive more FDI than those without investment treaties. For these reasons, we also control for the number of investment treaties host countries have signed and ratified as well as WTO membership.

Policy uncertainty. We also control for the level of policy uncertainty stemming from host country political constraints in our robustness test. This was operationalized through the political constraints (POLCON) index developed by Henisz (2000). POLCON index makes use of the structure of a government in a given host country and the political views represented by the different levels of that government to measure on a zero to one scale the level of political constraints on policy changes in a specific host country in a particular year.

ESTIMATION TECHNIQUE

We used FDI inflows as the unit of analysis for this study. It is possible that the worldwide increase in FDI is a major cause of the increasing trend in overall MNE- host country disputes. To mitigate these potential reverse causality problems of increasing FDI affecting host country MNEs disputes, we lagged FDI by one period. To tackle this problem more comprehensively, we, in addition, adopted a two-stage least squares (2SLS) regression method for our analysis. The use of 2SLS allows us to address the potential concern about a reverse causal relationship between FDI inflows and HCDS (Feinberg & Gupta, 2004; Veugelers, 1997). To reduce the skewness of the distribution of the dependent variable (FDI inflow), we take the natural log for this analysis. Our model is of the form:

$$FDI = \alpha + \beta \times HCDS_C^{1996-2017} + \sum_{i=1}^n \lambda^i Z_C^i + \varepsilon$$

Where HCDS is the existence of MNE host country dispute, and Z is set of country-specific variables representing both macro-economic, political, legal, and the institutional environments of the host country that are known in the literature as key determinants of FDI (Blonigen, 2005; Chakrabarti, 2001). In the 2SLS model, to assess HCDS' unique contribution to FDI inflow, in the first-stage regression (Model 1) we partial out the effect of these known determinants of FDI in the empirical literature, and the resulting residual values denoted γ -gamma was then used in the second stage (Model 2), and subsequent equations. Doing this help use isolates the variation in Z_i that is not correlated with ε (Bascle, 2008).

RESULTS

In table 3, we report the descriptive statistics and correlations of the variables used in this analysis. This includes the means, standard deviations, and correlation coefficients.

**** insert Table 3 and 4 around here****

Table 4 presents the result of the regression analysis. In the first stage (i.e., the reduced form equation), the theoretically known determinants of FDI are regressed on the dependent variable. Most variables in the model test in accordance with theoretical expectations: larger countries receive more FDI. Richer countries receive more FDI. Countries with well-developed natural resource endowment receive more FDI. Investment treaties have a positive effect on FDI inflow. Not surprisingly, a higher inflation level in a country deters FDI, although the regression coefficient of inflation is statistically insignificant. In model 2, we regressed the residuals γ -gamma of the known determinants of FDI on our dependent variable (FDI inflow). We find a positive significant relationship for both γ -gamma and HCDS ($\beta = 1.0002, p = < 0.01$) and ($\beta = 4.3711, p = < 0.01$), respectively. To directly test our hypothesis, in models 3 we introduced the

square term of host country dispute (HCDS²) (Aiken, West, & Reno, 1991). The regression coefficient was statistically significant ($\beta = -0.3523$, $p = < 0.01$). Keeping the square term of host country dispute (i.e. HCDS²) in the equation, in model 4, we tested the interaction effect of HCDS and number of investment treaties (*Treaties* Resource Rents*). We also controlled for host country institutional differences as well as political environmental stability. The results were statistically significant. With interaction terms included in the models, one cannot interpret the coefficients on the individual components in the conventional way (Braumoeller, 2004). Instead, the results of HCDS in a model with a significant interaction term (*Treaties* Resource Rents*) is the effect of investment treaties on FDI flow when the HCDS variable is zero (Braumoeller, 2004; Neumayer & Spess, 2005). These results from model 4 confirm a widely known finding in the literature that host country institutions matters in attracting FDI (Meyer, Estrin, Bhaumik, & Peng, 2009; Peng, 2002). It also confirms Neumayer and Spess (2005) and Albino-Pimentel, Dussauge, and Shaver (2018) findings that the existence of investment treaties have a substantial impact on firms' FDI location decision while controlling for traditional determinants of foreign investment location choice and other host country variables. It follows from our estimation that both γ -gamma and HCDS², the interaction term all have a statistically significant effect on FDI inflow. The POLCON variable was also positive and statistically significant.

Although necessary, a significant coefficient alone is not enough to establish a quadratic relationship (Haans, Pieters, & He, 2016; Lind & Mehlum, 2010). For this, we followed the three-step procedure proposed by Lind and Mehlum (2010) and recommended by Haans, Pieters, and He (2016). According to Lind and Mehlum (2010), to test properly for the presence of a quadratic relationship, (1) the coefficient must be significant and of the expected sign. An inverted U-shaped relationship exists if the dependent variable first increases with the independent variable at a decreasing rate to reach a maximum, after which the dependent variable decreases at an increasing rate (Aiken, West, & Reno, 1991; Haans, Pieters, & He, 2016). (2) The slope must be sufficiently

steep, and (3) the turning point needs to be located well within the data range. The coefficient of the squared term HCDS² is negative and significant ($\beta = -0.3312, p = < 0.01$). Following Haans, Pieters, and He (2016) recommendation to report the “turning point” due to its economic and statistical importance, we conduct a partial derivation of the regression function to explore the hypothesized relationship further: FDI inflow = $-0.3312 \text{ HCDS}^2 + 7.2488$ reaches its maximum when $\frac{\partial \text{FDI inflow}}{\partial \text{HCDS}} = -0.6624 \text{ HCDS} + 7.2488 = 0$, which occurs when $\text{HCDS} = \frac{-7.2488}{-0.6624} \cong 10.9$. This suggests that, in general, MNEs may continue to invest in a host country where the host government has intervened in their operations or the operations of the peers and competitors up until about 10.9 interferences, at which point further host government interventions begin to deter MNEs from investing in that country. The results support our hypothesis for this study, which predicts that there is an inverted U-shaped relationship between host government interference and FDI flow³. It is important to mention here that this does not explain exit or disinvestment as MNEs vary in their response to host government interference and host country risk management (Holburn & Zelner, 2010). FDI continues to increase until 10.9 host government interferences before it decreases. Why? The answer lies in treaties. Host governments that sign investment treaties send positive signals to MNEs, and the accumulation of numerous treaties demonstrates a stronger general commitment to protect investors and to promote a healthy

³ 10.9 cases may sound very high to some readers, however, a detailed examination of the ISCID data revealed that this is not unusual. When host governments interference in one sector, many firms in the sector seek dispute settlements Dolzer, R. & Schreuer, C. 2012. *Principles of international investment law*. 2nd ed. Oxford: Oxford University Press.. International arbitration cases seem to come in “batches”, for instance, 2003 when Argentina suspended the tariff adjustment formula for gas transportation, 20 gas producing companies instituted separate arbitration proceedings against Argentina Bank, W. 2003. ICSID Annual Report 2003.. In 2015, after its revocation of the incentives for companies to use renewable energy sources 19 aggrieved investors initiated HCDS proceedings against Spain in that same year Arp, B. 2016. Charanne B.V. v. Spain. *American Journal of International Law*, 110(2): 327-333..

investment climate for all foreign investors (Allee & Peinhardt, 2011). As FDI decisions are *ex-ante* to host government interventions (Büthe & Milner, 2009) and ICSID cases tend to be lengthy⁴, firms are likely to continue to invest in a host country with investment treaties even in the face of pending investor-state arbitration disputes. However, as the number of interference and related disputes keep increasing, some firms become wary and begin to reduce the level of investments in the host country. Take the case of FDI from Germany to Thailand for example, as Wellhausen (2015) account, in 1990, when Thailand contracted with a German MNE to build a major new toll road, but in 1998 it (Thailand) signed a similar contract with a competing firm from Hong Kong and refused to allocate land for an exit ramps and restricted toll adjustments by the German MNE. FDI from Germany to Thailand continued until 2005 when the ultimately German exited Thailand and initiated ICSID procedure. This suggests at least in part that all other things being equal, other firms may continue to invest in a destination country even in the face of host government intervention in operation of their competitors and peers until a tipping point is reached before they divert capital in response to the host government interference. This tipping point is 10.9 interferences. Our results suggest that MNEs do not necessarily see host governments interference in the operations of their peers and competitor as the poisoning of which reason they must exit or reduce their investment in the host country, rather, they wait and see. To guide our assessment on whether we, in fact, have an inverted U-shaped relationship between FDI inflow and host government interference, we plot the relations in figure 2. This further provides supporting evidence of the relationship (Haans, Pieters, & He, 2016).

**** insert figure 2 around here****

INCOME GROUPS

⁴ For instance, a claim initiated by ABCI Investments Limited against the Republic of Tunisia in 2004 for the alleged expropriation of its assets in Tunisia is still pending, 15 years after the initial submission.

Recent studies show that there is a rapid growth in FDI inflow, particularly in developing countries (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2010; George, Corbishley, Khayesi, Haas, & Tihanyi, 2016; Kolstad & Wiig, 2012). However, the greatest challenge to MNEs in developing countries is the persistence of host government interferences due to institutional voids (George, Corbishley, Khayesi, Haas, & Tihanyi, 2016; Khanna & Palepu, 2010). Consistent with theory and our hypothesis, we also test the effect of host government interference on FDI inflow in different groups of countries. The World Bank (2019) classifies countries into four groups: *Low-income countries*, *Lower middle-income countries*, *Upper middle income*, and *High income*. To test our hypothesis on different income groups, we relied on the World Bank (2019) classification of countries and split the countries accordingly. Table 5 present the analysis with different income groups. Model 1 contains the results for only low -income countries. Model 2 contains results for lower-middle-income countries. Model 3 and 4 contain results for upper middle income and high-income countries, respectively. We found further support for our hypothesis. Except for low-income countries, we find that the existence of an investment dispute between a host government and foreign firms does not immediately deter FDI decisions. However, over time, as the number of HCDS cases increases, firms begin to shun host countries that interferer in MNEs' operations. The quadratic term (HCDS²) is negative and significant for Lower middle income ($\beta = -1.1516, p = < 0.01$), Upper middle income ($\beta = -0.4880, p = < 0.05$) and High-income countries ($\beta = -0.3060, p = < 0.01$). A partial derivation of the regression function for lower-middle countries: $FDI\ inflow_{lower\ middle\ income} = -1.1516HCDM^2 + 11.8525$ reaches its maximum when $\frac{\partial FDI\ inflow_{lower\ middle\ income}}{\partial HCDS} = -2.3032 + 11.8525 = 0$, which occurs when $HCDS = \frac{11,8525}{2.3032} \cong 5.1$. For upper middle-income countries: $FDI\ inflow_{Upper\ middle\ income} = -0.4880 HCDM^2 + 7.7349$ reaches its maximum when $\frac{\partial FDI\ inflow_{Upper\ middle\ income}}{\partial HCDS} = -0.9760 + 7.7349 = 0$, which occurs when $HCDS = \frac{7.7349}{0.9760} \cong 7.9$. For high-income countries:

FDI inflow_{High income} = $-0.3060\text{HCDS}^2 + 7.1463$ reaches its maximum when

$$\frac{\partial \text{FDI inflow}_{\text{High income}}}{\partial \text{HCDS}} = -0.6120 + 7.1463 = 0, \text{ which occurs when } \text{HCDS} = \frac{7.1463}{0.6120} \cong 11.67.$$

This suggests that, for high-income countries, firms are more likely to continue to invest in a destination country up until about 12 interferences before FDI inflow begins to decline due to host government interferences. However, for low middle-income countries, FDI decreases with just 5 interferences. These relationships are depicted in figure 3 below.

**** insert Table 5 around here****

**** insert figure 3 around here****

ROBUSTNESS TESTS

To evaluate the robustness of our findings, we carry out additional analyses. First, although the use of lagged dependent variable minimizes the risk of omitted variables and mitigate simultaneity bias as well as potential reverse causality problems (Feinberg & Gupta, 2004; Veugelers, 1997; Witte, Burger, Ianchovichina, & Pennings, 2016), this lag length of one period is somehow arbitrary, as a robustness check, we investigated the robustness of our model using different lag periods. Maintaining the lag of one year, we find that our results were consistent for two, three, and four lagged periods. In addition, we examine whether the effect of HCDS on FDI inflow vary between democratic countries and non-democratic countries. To do this, we replaced POLCON with *polity* scores, which we obtained through the polity project (Marshall & Jaggers, 2017). The *polity* indicators are widely used in studies of international business (Dow & Karunaratna, 2006; Kobrin, 1976) to account for autocracy and democratic host countries. *Polity* scores vary from 10, for full democracies, to -10, for full dictatorships. Consistent with our first estimation, HCDS did

not immediately deter FDI inflow ($\beta = 0.354, p = < 0.01$). *Polity* was positive and significant ($\beta = 0.0221, p = < 0.01$). This implies that consistent with previous research (Jensen, 2003), democratic countries do attract more FDI. Tables 6 and 7 report the results of the different lag periods and the alternative estimation controlling for the democratic and non-democratic governance.

**** insert tables 6 and 7 around here****

DISCUSSION AND CONCLUSION

Motivated by the increasing level of MNE host country confrontations in the past two decades, we have provided theoretical arguments and empirical evidence to demonstrate how host government interference in MNEs' operations and the subsequent international investment dispute settlement affect FDI inflows. We find that host country policy risk arising from government interference in MNEs operations does not immediately deter FDI decisions in the host environment. However, there is a tipping point at which further interference begins to deter FDI inflow in a host country. This is consistent with Holburn and Zelner (2010), suggesting that host-country policy risk may not necessarily deter FDI but might even attract it in some cases.

At first sight, one might find it intriguing that host government interference does not poison the host environment and deter firms from investing in a host country. Arguably, it might, but FDI decisions are long-term commitments with high initial sunk costs that cannot easily be recouped. This suggests that MNEs may stay in a host country, even in the face of increasing uncertainties. This is an example of economic hysteresis, the tendency for effect such as FDI in a host country to persist well after the cause that brought it about (an FDI friendly government at a time) has disappeared (Dixit, 1989; 1992; Parsley & Wei, 1994). MNEs may remain in a host country for an extended period, even as uncertainty levels in the host country increases with the expectation that

the host environment will improve (Axarloglou & Kouvelis, 2007). We also speculate that MNEs interpret host governments' interference in the operations of peers and competitors as a unique problem for their peers and competitors, but not universal to the host environment. Our statistical analysis of all FDI location choices in a sample consisting of almost the entire population of host countries from 1996 to 2017 provides robust empirical support for our assertion that host governments that interfere in MNEs' operations do not poison their host environment. With decades of host country interferences and subsequent international investment cases at ICSID, perhaps firms are beginning to understand that host governments have divergent expectations from foreign investors. While investors may be interested in maximizing returns, host governments have more complex preferences for governance and development, as such periodic tensions with host country officials will not simply disappear (Makhija, 1993; Stevens, Xie, & Peng, 2016). As such, some level of host government interference is expected and seen as a normal part of international business, leading MNEs to choose a "wait and see" strategy as the optimal response in the face of increasing uncertainties stemming from host government actions.

Our results have significant implications for theory and practice. From host governments' perspective, our findings confirm a widely held notion that a country's economic performance over time is determined mainly by its political, institutional, and legal environment. The results suggest that host governments that want to attract more FDI to create employment, bring foreign technology, etc., must avoid interfering with MNEs' operations. Although membership in external institutions such as ICSID provides avenues to reduce investors' concern over host government-related risk, host governments should fully respect their IIA commitments to avoid international confrontation with foreign firms. Worldwide, as countries are setting national targets and determining indicators for monitoring advances towards the newly adopted sustainable development goals (SDGs), governments must not forget their obligations to foreign firms whose interest may misalign with SDG goals.

Naturally, our analysis has limitations. First, we draw on data from a single international arbitration (i.e., ICSID) and do not include host government MNE disputes from other arbitration institutions. This may create a selection bias if some countries only relied on arbitration tribunals other than ICSID or the World Bank Group. Unfortunately, we lack the data necessary to address the possibility of such bias econometrically. Most arbitration tribunals do not make arbitration disputes public (Buys, 2003; Lynch & Lynch, 2003). Other only report aggregate numbers, making it challenging to identify the countries involved. ICSID publicizes information through its website and various other publications such as UNCTAD's investment policy hub, about the nature, timing, and outcomes of proceedings and awards, making it possible to collect essential details about the cases and the parties involved. Second, some firms may decide against arbitration with host governments for fear of losing access to resources if they upset their host government. Such disputes will not appear in our data. Finally, international arbitration is a last-resort remedy for foreign firms. In the event of host government interference, IIAs require foreign firms to first and foremost pursue local remedies before international arbitration (Dolzer & Schreuer, 2012; Whittinghill, 2003), making the use of arbitration cases not representative of all potential interference and disputes with host governments. To those events, one can assume that local remedies put in place by host governments to resolve disputes with foreign MNEs are effective.

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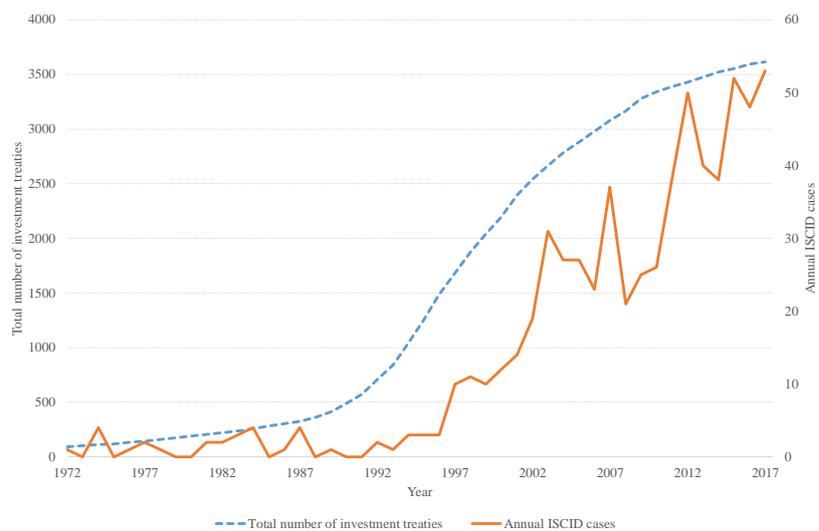
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Figure 1 Growth of investment treaties and ICSID cases 1972 - 2017.



Source: UNCTAD's new Investment Policy Hub and IIA Database (2018)

Table 1 Variables, Definitions and Data Source

Variable	Definition	Data Source
FDI inflow	Annual inflow of Foreign direct investment	UNCTAD
Host government interference	Known investor-host country disputes under international arbitration at ICSID and ICC	UNCTAD

Market size	Population - inhabitants in a country	World Bank
GDP per Capita	Country gross domestic product per capital	"
Institutions	The average of Rule of law, Regulatory Quality and governance effectiveness	"
POLCON	POLCON index	Henisz (2000)
Inflation	Inflation rate	World Bank
Resources Rent	Total natural resources rent as % of GDP	World Bank

Table 2 Countries with the most frequent number of HCDS cases

Country	Cases (as of 2017)	Country	Cases (as of 2017)
Argentina	60	Cyprus	4
Spain	48	Armenia	4
Venezuela	46	Iraq	4
Czech Republic	40	Estonia	4
Egypt	32	China	4
Mexico	29	Belize	3
Poland	29	Sri Lanka	3
Canada	28	Slovenia	3
India	27	Mozambique	3
Ukraine	26	Australia	3
Russia	24	Thailand	3
Ecuador	23	Senegal	3
Hungary	18	Ethiopia	3
Kazakhstan	18	Germany	3
USA	16	Congo	3
Croatia	16	Zimbabwe	3
Peru	14	Yemen	3
Bolivia	14	Belgium	3
Georgia	13	Nicaragua	3
Libya	13	Korea	3
Romania	13	Oman	3
Slovakia	13	El Salvador	3
Kyrgyzstan	13	Paraguay	3
Turkmenistan	11	Burundi	3

Latvia	11	The Gambia	3
Italy	11	Bahrain	2
Moldova	11	Kuwait	2
Algeria	10	Benin	2
Panama	9	Ghana	2
Jordan	9	Honduras	2
Serbia	9	Azerbaijan	2
Uzbekistan	9	Mauritius	2
Costa Rica	9	Lesotho	2
Pakistan	9	Malaysia	2
Turkey	8	Morocco	2
Vietnam	8	Gabon	2
Bulgaria	8	Grenada	1
Chile	7	Nigeria	1
Indonesia	7	Barbados	1
Madagascar	6	Syria	1
Albania	6	France	1
Colombia	6	Tajikistan	1
Montenegro	6	Guyana	1
Saudi Arabia	5	Myanmar	1
Bosnia and Herzegovina	5	Sudan	1
Greece	5	Iran	1
Laos	5	Kenya	1
Philippines	5	Trinidad & Tobago	1
Lebanon	5	Bangladesh	1
Uruguay	5	Tunisia	1
Lithuania	5	Cape Verde	1
Guatemala	5	Cameroon	1
Macedonia	5	South Africa	1
Dominican Republic	5	Austria	1
Tanzania	4	Equatorial Guinea	1
United Arab Emirates	4	Uganda	1
Mongolia	4	UK	1

Source: UNCTAD's new Investment Policy Hub and IIA Database (2018)

Table 3 Descriptive statistics and correlations

	Mean	S.D.	Min	Max	1	2	3	4	5	6	7	8	9	10	11
1 FDI inflow	411.963	100.994	20.886	722.193	1										
2 HCDS	0.264	0.929	0.000	20.000	0.181***	1									
3 Institutions	-0.151	0.953	-2.551	2.098	0.545***	0.0241	1								
4 POLCON	0.302	0.213	0.000	0.726	0.277***	0.0718***	0.501***	1							
5 Market Size	42.559	143.712	0.000	1357.380	0.310***	0.0827***	0.0125	0.00959	1						
6 GDP per Capita	9.023	14.395	0.000	103.059	0.501***	0.0351**	0.734***	0.302***	-0.0300*	1					
7 Resources Rents	8.393	12.015	0.000	82.530	-0.108***	-0.0418**	-0.332***	-0.308***	-0.0639***	-0.103***	1				
8 Inflation	10.310	89.223	-31.566	4800.532	0.0144	-0.00932	-0.0686***	-0.0409**	-0.00932	-0.0473***	0.0959***	1			
9 Treaties	31.153	28.611	0.000	160.000	0.578***	0.220***	0.386***	0.187***	0.349***	0.321***	-0.141***	-0.0221	1		
10 Polity	3.410	6.272	-10.000	10.000	0.268***	0.0899***	0.534***	0.725***	-0.0237	0.267***	-0.477***	-0.0469***	0.124***	1	
11 WTO	1.730	0.444	1.000	2.000	0.188***	0.0114	0.224***	0.260***	-0.0227	0.165***	-0.254***	-0.0523***	0.0595***	0.361***	1

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Figure 2 Inverted U-Shaped relationship between host government interference and FDI

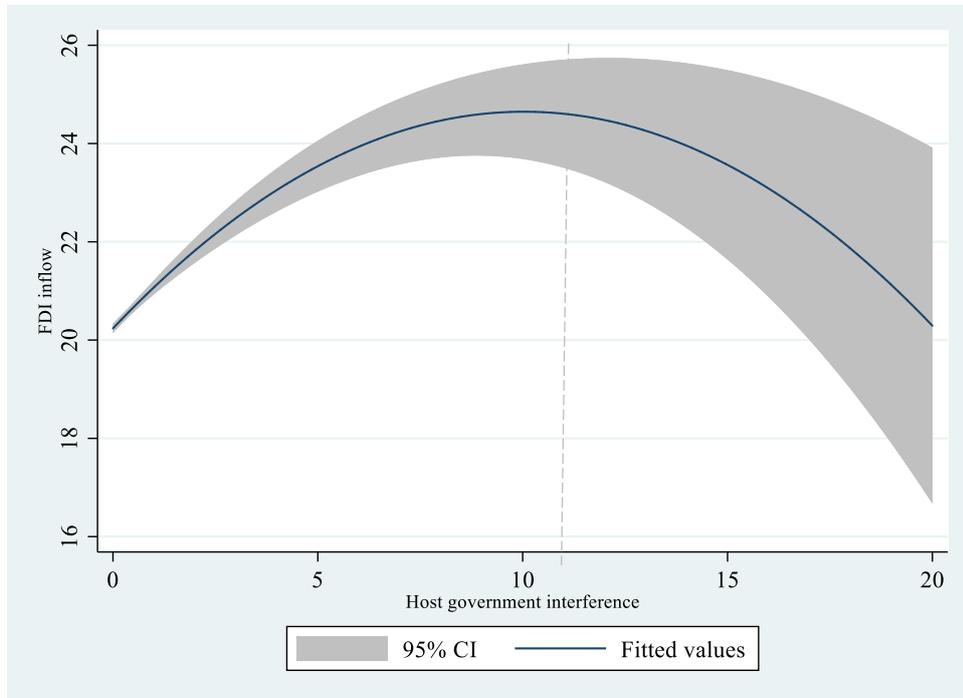


Figure 3 Inverted U-Shaped relationship between host government interference and FDI by Income Group

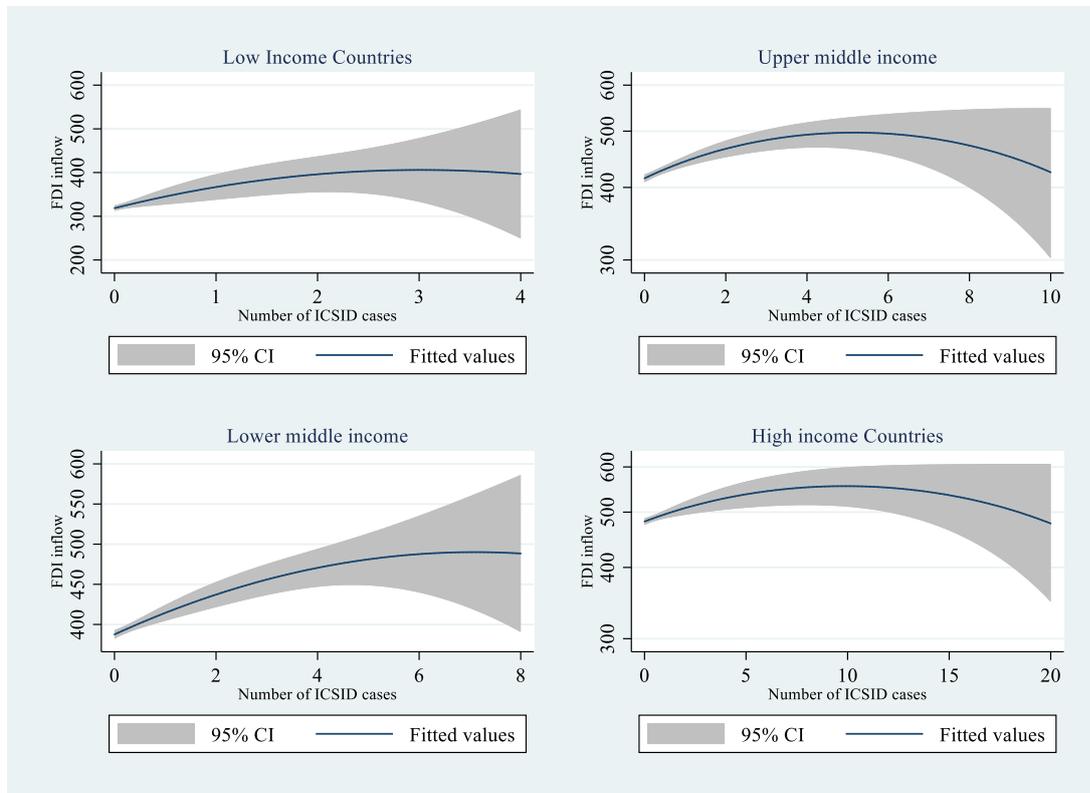


Table 4 Results of 2SLS regression of host government intervention and FDI inflow

VARIABLES	(1) Model 1	(2) Model 2	(3) Model 3	(4) Model 4
Market Size	0.4528*** (0.1073)			
GDP per Capita	0.9616*** (0.2026)			
Resources Rents	0.9945*** (0.1657)			
Inflation	-0.0058 (0.0104)			
Treaties	1.6631*** (0.1352)			
HCDS		4.3711*** (0.4417)	7.6754*** (0.6936)	7.2488*** (0.6144)
γ -gamma		1.0002*** (0.0079)	0.9989*** (0.0078)	0.9872*** (0.0072)
HCDS^2			-0.3523*** (0.0573)	-0.3312*** (0.0506)
Treaties*Resources Rents				0.0492*** (0.0017)
Institutions				8.3667*** (1.9951)
POLCON				9.2721*** (2.9302)
Constant	323.6153*** (5.0831)	412.6860*** (0.3998)	412.0875*** (0.4089)	401.4350*** (1.0770)
Observations	2,923	2,923	2,923	2,800
R-squared	0.1510	0.8542	0.8561	0.8856
Number of countries	143	143	143	140
First stage	Yes			

Standard errors in parentheses
 *** p<0.01, ** p<0.05, * p<0.1

Table 5 Results by Income Groups

VARIABLES	(1) Model 1	(2) Model 2	(3) Model 3	(4) Model 4
HCDS	-0.3304 (1.5392)	11.8525*** (1.9275)	7.7349*** (1.3244)	7.1463*** (1.3518)
γ -gamma	1.0153*** (0.0036)	0.9725*** (0.0162)	0.9872*** (0.0151)	0.9374*** (0.0177)
HCDS^2	0.7031 (0.5857)	-1.1516*** (0.3879)	-0.4880** (0.2193)	-0.3060*** (0.0876)
Treaties*Resources Rents	0.0831*** (0.0031)	0.0499*** (0.0038)	0.0484*** (0.0028)	0.0445*** (0.0037)
Institutions	1.3794 (1.0373)	2.0618 (3.9201)	23.1980*** (3.8176)	17.6318*** (5.6180)
POLCON	6.3091*** (1.5067)	19.3948*** (4.9386)	3.1177 (5.5438)	-5.6970 (13.0688)
Constant	349.6859*** (2.4433)	396.5999*** (9.4316)	412.1004*** (11.0171)	420.1778*** (12.0220)
Observations	536	686	807	771
Number of countries	28	33	41	38
Income Group	Low Income	Lower middle income	Upper middle income	High income

Standard errors in parentheses
 *** p<0.01, ** p<0.05, * p<0.1

Table 6 Estimation with lagged dependent variable

VARIABLES	(1) Model 1	(2) Model 1	(3) Model 1
HCDS	11.4971*** (2.5801)	12.4392*** (2.7646)	12.8358*** (2.8754)
<i>γ-gamma</i>	0.8269*** (0.0227)	0.7227*** (0.0244)	0.6433*** (0.0256)
WTO	18.9131*** (3.7461)	20.6870*** (4.0450)	19.7483*** (4.2438)
HCDS^2	-0.5090** (0.2162)	-0.4688** (0.2329)	-0.4343* (0.2433)
Constant	385.4900*** (6.7870)	381.6680*** (7.3297)	382.4160*** (7.6911)
Observations	2,298	2,292	2,274
R-squared	0.4081	0.3230	0.2630
Lagged period	Two	Three	Four

Standard errors in parentheses
 *** p<0.01, ** p<0.05, * p<0.1

Table 7 Estimations controlling for democratic and non-democratic governance forms

VARIABLES	(1) Model 1	(2) Model 2	(3) Model 3
Market Size	0.4528*** (0.1073)		
GDP per Capita	0.9616*** (0.2026)		
Resources Rents	0.9945*** (0.1657)		
Inflation	-0.0058 (0.0104)		
Treaties	1.6631*** (0.1352)		
HCDS		4.3711*** (0.4417)	7.1478*** (0.6090)
γ -gamma		1.0002*** (0.0079)	0.9863*** (0.0070)
HCDS^2			-0.3231*** (0.0502)
Treaties * Resources Rents			0.0486*** (0.0017)
Institutions			8.1021*** (1.9765)
Polity			0.7672*** (0.1648)
Constant	323.6153*** (5.0831)	412.6860*** (0.3998)	401.3745*** (0.8665)
Observations	2,923	2,923	2,850
R-squared	0.1510	0.8542	0.8878
Number of countries	143	143	140
First stage	Yes		

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1