

# With a Little Help From My Foreign Friends: Domestic Property Rights and Firm Ownership Structure\*

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November 6, 2017

## Abstract

How do firms protect themselves against infringements of their property rights? Existing explanations focus on bribery or capital flight. We offer a third mechanism: Firms can gain indirect coverage from the property rights available to foreign firms under international law. Investment agreements protect the assets of foreign firms, but not of domestic firms. We demonstrate that this segmentation of the property rights environment creates a rationale for international financial linkages between firms. To gain protection against their own government, domestic firms seek investments by foreign firms that are covered by international investment law. If the government is less likely to violate the property rights of covered foreign firms, assets held jointly with domestic firms are indirectly protected as well. We present systematic evidence from data on firm activities in countries with investment agreements with the United States.

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\*We thank Vincent Arel-Bundock, Bill Clark, Rick Cupitt, Nehemia Geva, Florian Hollenbach, Soo Yeon Kim, Yewon Kwon, Haillie Lee, Quan Li, Sonal Pandya, Michael Plouffe, Erica Owen, Michelle Taylor-Robinson, and Rachel Wellhausen for comments. Weiwen Yin provided outstanding research assistance.

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Domestic firms often suffer losses at the hands of their own government. Through regulation, taxation, or outright expropriation, government policies can reduce the value of a firm's assets. Where property rights are strong, firms have recourse against such actions. When property rights are weak, firms may not be able to hold the government accountable. How can firms protect themselves against such infringements in environments with weakly institutionalized property rights? Existing explanations focus on leveraging political connections and bribery (Shleifer and Vishny, 1994; Treisman, 2000; Wang, 2014a); alternatively, firms may escape the threat of predation by moving their assets abroad and out of the government's reach (Przeworski and Wallerstein, 1988; Boix, 2003; Freeman and Quinn, 2012). We offer a third explanation that requires neither exit nor bribery: Where firms lack effective property rights domestically, they can benefit indirectly from the system of property rights available to foreign firms through international law; they do so by ceding ownership of a portion of domestic assets to foreign firms.

Foreign firms frequently enjoy higher property rights standards than domestic firms. Since the 1950s, governments have spread property rights at the international level through international investment law. Bilateral investment treaties and investment provisions in trade agreements frequently allow foreign firms to file claims against governments in international tribunals if they perceive their rights to be violated. By raising the cost of property rights violations, both through compensation to be paid and through the deterrent effects of arbitration on future investments, these agreements reduce the threat of government predation. Hence, for foreign firms, international law can substitute for weak domestic property rights (Tobin and Rose-Ackerman, 2003; Neumayer and Spess, 2005; Allee and Peinhardt, 2011).

Investment agreements protect foreign firms, but not domestic firms; the assets of domestic firms are not covered, and domestic firms are not compensated for losses, through investment agreements. Instead, domestic firms have to rely on domestic law. We argue that this segmentation of the property

domestic and foreign firms, through which a foreign firm covered by international law acquires a financial interest in a domestic firm. These linkages allow domestic firms to benefit from the protections that international law provides to foreign investors: If the government is reluctant to violate the property rights of a foreign firm, because it is protected by international law, assets held jointly with domestic partners are indirectly protected as well.

Firms and governments are clearly aware of this opportunity. For instance, in 2011, La Mina, a Panamanian firm, formed an international partnership with TGGE, a U.S. firm; the government of Panama maintained, and an international tribunal concurred, that this partnership was formed for the sole purpose of gaining access to international arbitration. Such partnerships with foreign firms covered by international law should be most attractive where domestic property rights are weak. Then, domestic firms see the largest benefits from partnerships with foreign firms and their access to international investment law.

Data from the activities of firms in countries with investment agreements with the United States – the largest and deepest financial market – provide support for these expectations. We construct an original data set of mergers and acquisitions through which a U.S. firm acquires a financial interest in a domestic firm. We show that in countries with weaker property rights, more domestic firms form relationships with U.S. firms through mergers and acquisitions. We establish that this result is driven by the protections available to foreign investors under international law: The negative association between property rights and partnerships between firms is reversed for domestic firms as well as for foreign firms that are not covered by international law. Weaker property rights do not encourage, and instead discourage, partnerships in countries that have no investment treaties with the United States and in countries that signed investment agreements that lack explicit protections for investors. Finally, we report that domestic property rights also influence the nature of these partnerships. Foreign ownership shares increase where property rights are weaker, plausibly in an attempt to attract foreign partners and to more effectively deter government predation.

In addition to providing a theory of how firms gain protection against their own governments, we offer a new perspective on international financial relationships. The literature on foreign direct investment typically emphasizes the motivations of multinational corporations for investing abroad and how they manage political risk (e.g., Moran 1973; Dunning 1981; Markusen 1995; Henisz 2000; Antras, Desai and Foley 2009). The motivations of domestic firms for partnering with foreign firms have often been ignored (Pandya, 2016). By ceding ownership to foreign partners, domestic firms can benefit from international law that otherwise would not be available to them. Seeking access to the umbrella of property rights that protects foreign investors under international law is an important determinant of international investments. Differential access to international law arises as a source of comparative advantage in explaining international financial relationships; firms trade property for property rights. More generally, our paper highlights the ownership structure of firms – including the choice of investment partners from specific jurisdictions as an avenue to access the protections afforded to these partners by international law – as a fruitful area for future research.

The paper contributes to three additional lines of research. First, our argument shares some similarities with the literature on corporate governance and domestic shareholder rights, which starts from the observation that weak minority shareholder protections tend to depress equity values. To restrain controlling shareholders and to drive up equity prices, firms therefore cross-list equity in developed country markets with stronger shareholder protections (Coffee, 2002; Doidge, 2004; Siegel, 2005). In contrast to this literature, we are concerned not with the protection of minority shareholders against insiders, but with the protection of asset owners against their own government; and we do not emphasize the role of foreign securities law, but the access of foreign firms to international law. Thus, the motivation of domestic firms in this literature differs from the motivation we emphasize. While subjecting assets to the stricter securities laws of a foreign jurisdiction helps deter predation by corporate insiders, it provides no recourse against government predation. Partnerships with foreign firms allow domestic asset

owners to gain such protection, especially where it is lacking domestically, and we document empirically that this mechanism depends on the access of foreign firms to international law.

Second, linkages between firms through production networks and global supply chains have been an important component of recent political economy models (Jensen, Quinn and Weymouth 2015). For instance, Johns and Wellhausen (2016) emphasize how integration in supply chains protects foreign firms: then, domestic firms have incentives to lobby the government on behalf of foreign business partners. We instead direct attention to financial relations between firms and the ownership structure of firms. Domestic firms that enjoy privileged access to the government can be effective advocates for foreign firms, as Johns and Wellhausen emphasize. However, for domestic firms that lack those connections, or that are concerned about losing them, foreign firms are the ones providing the protection. In both cases, cross-border linkages deter government predation, but the source of protection differs. Protection is based on political connections and bribery in the first case, but on international law and arbitration in the second case.

Third, we highlight a novel effect of capital mobility. Capital mobility has long been viewed as a constraint on governments (Przeworski and Wallerstein, 1988; Basinger and Hallerberg, 2004; Cai and Treisman, 2005), because domestic asset owners can threaten to move their assets abroad and thereby out of reach of their government. Our theory emphasizes how not just capital outflows but also capital inflows can constrain governments: Domestic asset owners can constrain their government by attracting foreign capital that is covered by international law. Domestic firms do not have to threaten capital flight. They can stay put if they instead forge relationships with covered foreign firms. Investments from covered foreign firms, in the form of capital inflows, therefore reduce the need of domestic firms to exit their home market.

The next section discusses how domestic firms can rely on international financial relationships for property rights, particularly when domestic property rights are weak. The subsequent section presents data to assess this claim. We conclude with thoughts for future research.

## Foreign partners as a source of property rights

In this section, we discuss how domestic firms may gain indirect protection against government predation by forming financial relationships with foreign firms that have access to arbitration under international law. Then, joint asset ownership deters the government from implementing damaging policies and thereby offers indirect cover for the domestic firm. These partnerships for protection should be most prevalent where property rights are weak; and they should be limited to foreign firms that are covered by international law. The theory is based on a simple formal model, which is presented in the appendix.

Domestic firms frequently suffer losses to the value of their assets because of domestic policy choices. Government policies may reduce the firm's profits through increased taxation, breach of contract (many governments promise investment inducements, but may not follow through with those promises), or new regulation (such as environmental legislation that reduces a firm's profits). In the following, we refer to this as the government implementing a damaging policy. We make no presumption that this reduction in the value of the firm's assets is intentional. The effect on the value of firm assets may be a side effect of regulatory policies, for instance. Nor do we assume that the government is necessarily represented by a unitary actor or responsible for the initial loss. Firms may be concerned about violations of intellectual property rights by competitors or, in transactions between firms, about payment for delivered goods and services. The government's failure to enforce these contracts impartially may also be interpreted as a damaging policy. Likewise, decisions by individual bureaucrats or local governments may affect the value of a firm's assets. Tolerating these decisions, or failing to assert control over its bureaucracy, can again be interpreted as a damaging policy by the government.

Implementing the damaging policy may be beneficial to the government. The government may receive tax receipts or support from affected interest groups for implementing these policies. The government may also derive material or reputational benefits for not implementing

policies harmful to business interests. We assume that the net benefit of implementing the policy is the private information of the government; the firm knows only how the net benefit is distributed. Hence, the domestic firm cannot perfectly anticipate whether the government will implement the damaging policy.

Domestic property rights shape the ability of a firm to obtain compensation if the government implements a damaging policy. Strong property rights are not equivalent to the absence of government action: Governments in countries with strong property rights may still enact legislation that is harmful to firm profits. Strong property rights imply that the firm has recourse against such actions and is compensated for the damage. This is consistent with the possibility of efficient breach. If the government receives high net benefits from implementing the damaging policy – for instance, because the costs of non-regulation become too large – it may implement the policy, fully expecting to compensate the domestic firm for the impact of the policy. This definition of property rights is closely tied to a strong rule of law environment, where domestic actors have recourse through the domestic court system against government policies that affect them adversely (see Barro 2000; Li and Resnick 2003; Nunn and Trefler 2015). Where domestic property rights are strong, the domestic firm is more likely to obtain a favorable court ruling and to be compensated for the damaging policy or to have the offending policy reversed. In turn, where property rights are weak, firms have to be more concerned about government predation through the implementation of damaging policies.

For firms, the protection of domestic property through a rule-based system is usually preferable to alternative mechanisms, such as reliance on political connections. Although political connections to bureaucrats and policy-makers can be financially profitable while they exist (Krueger, 1974), a firm that is privileged by a government today cannot guarantee that these privileges will continue in the future. For instance, where property rights are weak, changes in a government's support coalition or in the government's leadership may induce the government to implement damaging policies (Albertus and Menaldo, 2012); mere rumors of im-

pending leadership change can depress the assets of politically connected firms, as Fisman (2001) has shown in the context of firms connected to the Indonesian leader Suharto during his final years in office. Although politically connected elites often amass their wealth due to preferential policies, this does not mean that they will always be protected. This volatility of policy and privileged access to the government, without recourse to a rule-based system, can be concerning for even the most influential elites, as recent examples have shown: Many formerly connected oligarchs in Russia and China have had their property rights stripped away, forcing them to divest and flee or risk imprisonment (as in the prominent cases of Mikhail Khodorkovsky and Xiao Jianhua).

In an attempt to gain protection against government actions, domestic firms can form financial partnerships with foreign firms that are covered by international law. A partnership with a foreign firm is any transaction in which the foreign firm acquires some financial interest in the domestic firm. A partnership therefore does not imply that the domestic firm moves its assets abroad and out of the government's reach. Instead, the domestic firm cedes ownership of a portion of its assets to a foreign firm; the assets remain within the government's jurisdiction.

Where a foreign firm is covered by international law, such as through a bilateral investment treaty or a trade agreement with investment protections, it enjoys additional protections over domestic firms. Investment law commonly allows foreign investors to dispute government actions in an international tribunal if they perceive their rights to be violated. The International Centre for Settlement of Investment Disputes (ICSID) is the most prominent tribunal, housed at the World Bank. Firms can file a claim for compensation if their assets are negatively affected. Commonly, investment agreements acknowledge the right of governments to implement damaging policies that are in the public's interest and are non-discriminatory, as long as they provide "prompt, adequate and effective compensation"<sup>1</sup> for any damage to foreign assets. If a ruling is issued, the reputational and economic costs of not following through on a ruling are

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<sup>1</sup>See <http://www.state.gov/documents/organization/188371.pdf> for the U.S. agreement template.



often sufficient to compel governments to provide compensation to foreign investors (Kerner, 2009). About two thirds of cases brought before arbitration bodies result in a settlement or a ruling in favor of the investor (Wellhausen, 2016). Moreover, arbitration proceedings, and even more so rulings against a government, often feature prominently among investors, which has long-lasting costs for governments in terms of lost investment opportunities. Governments indeed cite concerns over their reputation as one of the reasons they are willing to abide by rulings (Desai and Moel, 2008).

Additionally, investment law often has stipulations about what constitutes permissible government regulation that go beyond what would be covered under domestic law. These protections can be far-reaching. As noted in a 1984 ruling against Iran, “The intent of the government is less important than the effects of the measures on the owner [of the assets], and the form of the measures of control or interference is less important than the reality of their impact.”<sup>2</sup> These features of investment agreements have drawn strong criticism, partly because they grant foreign firms effectively higher property rights standards than what is available to domestic firms – both in terms of scope and strength of the protections (Pelc, 2017).

This implies that foreign firms frequently have better recourse against government actions than domestic firms. In addition to whatever recourse is available domestically, foreign firms enjoy access to a rule-based system of property rights through international law. Beyond this access to arbitration, investment agreements also provide clear standards against which government behavior can be evaluated by other actors, which makes it easier to identify violations and facilitates the creation of reputational penalties. By contrast, where appropriate government behavior is vaguely defined, violations are more difficult to assess (Abbott and Snidal, 2000). In brief, investment agreements protect foreign investors “above and beyond what can be achieved with domestic law”; domestic investors, meanwhile, “must face a legal system that

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<sup>2</sup>Tippetts, Abbott, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran, 6 Iran-U.S. CTR 219, pp. 225-226.

is often slower, more capricious and less investor friendly” (Kerner, 2009, pp. 78-80). That international firms typically enjoy higher property rights standards than domestic firms is also evidenced in surveys and expert interviews. Even where foreign firms perceive substantial political risks, they still receive better treatment than their domestic counterparts (Aisbett and Poulsen, 2016).

While investment agreements allow foreign firms to submit claims for arbitration, domestic firms do not gain coverage under investment agreements. For instance, when the German government decided in 2011 to phase out the production of nuclear energy, the owners of German nuclear power plants perceived the decision to infringe on their property rights. They had made large investments in nuclear power plants, which were now to be phased out much sooner than initially projected, reducing the value of their investments. For German energy companies, the only legal recourse against this decision was to use the domestic court system, resulting in the filing of legal claims at the German constitutional court. Vattenfall, a Swedish energy company that had recently invested in two German nuclear power plants, filed claims at the German constitutional court as well but, being uncertain of the outcome in the German court, also filed a claim at ICSID in 2016 – a forum that is not available to German energy companies, because investment agreements do not cover firms against their own government.<sup>3</sup>

The coverage of foreign firms under international law makes them attractive partners for domestic firms. Under common provisions in investment agreements, the foreign firm gains access to arbitration as long as it has a financial interest in the domestic firm. These provisions generally apply to broad asset classes. In addition to covering foreign direct investment, investment agreements signed by the United States provide coverage to the owners of “shares, stock, and other forms of equity participation in an enterprise,” as well as “bonds, debentures, other debt instruments, and loans.”<sup>4</sup> If the government implements a policy that reduces the

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<sup>3</sup>“Showdown um Deutschlands Atomausstieg.” *Die Zeit*, October 10, 2016.

<sup>4</sup>See <http://www.state.gov/documents/organization/188371.pdf> for the U.S. agreement template. Similar language is included in all U.S. investment agreements.

profits of a firm, actors with an ownership share in the firm suffer through a direct reduction in profits, lower equity prices or returns, or a higher risk of default on debt obligations.

The broad-based coverage has been validated by international arbitration tribunals. In 2005, Motorola filed an ICSID case against Turkey. Motorola had loaned \$2 billion to the Turkish telecommunications firm Telsim; the loan provided Motorola with no direct ownership or oversight capability. Following fraud allegations, the Turkish government took ownership of Telsim and placed “Turkey’s own financial claims against the telecom firm ahead of those of Motorola”.<sup>5</sup> The ICSID tribunal accepted jurisdiction in the case and a settlement between Motorola and Turkey was reached in the shadow of an impending tribunal decision. Coverage under common investment treaty provisions is not restricted to specific asset classes and requires only a financial interest.

Anecdotal evidence documents that domestic firms are aware of the possibility of obtaining protection indirectly by forming partnerships with foreign firms that are covered through investment agreements. In 2005, the Panamanian firm La Mina Hydro-Power Corporation (La Mina) was awarded – and later lost – a contract to build a power plant in Panama. When its attempts at domestic arbitration failed, La Mina formed an international partnership with the U.S. firm Transglobal Green Energy (TGGE). TGGE filed an ICSID claim against Panama in 2013 for breach of contract under the investment agreement between Panama and the United States. The Panamanian government challenged the jurisdiction of ICSID on five counts, among them that the partnership was created only “in order to create an international dispute over a pre-existing domestic dispute.” Because the partnership was created after La Mina lost the contract and domestic litigation had been resolved, TGGE should not have reasonably expected a profit from the defunct contract and ICSID ultimately ruled in Panama’s favor.<sup>6</sup> Although La Mina’s attempt to gain coverage ultimately failed, the example illustrates that domestic firms

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<sup>5</sup>[http://www.iisd.org/pdf/2005/investment\\_investsd\\_nov2\\_2005.pdf](http://www.iisd.org/pdf/2005/investment_investsd_nov2_2005.pdf).

<sup>6</sup>See the ICSID ruling for details, <http://www.italaw.com/sites/default/files/case-documents/italaw7336.pdf>.

are aware of the benefits of international partnerships for accessing arbitration.

Other firms have tried, with more success, to take similar strategies. In an ICSID case brought by Mobil Corporation in September 2007, the government of Venezuela accused Mobil of adding a Dutch company to its ownership structure merely to gain standing at ICSID through the Venezuela-Netherlands BIT: “Venezuela contends that the BIT does not provide a basis for ICSID jurisdiction over the dispute. It submits that Venezuela Holdings is a ‘corporation of convenience’ created in anticipation of litigation against the Republic of Venezuela for the sole purpose of gaining access to ICSID jurisdiction.” The Tribunal decided that ICSID did in fact have jurisdiction, referencing Article 25 of the ICSID Convention – even if Mobil added the Dutch owner with the explicit goal of gaining access to international law.<sup>7</sup>

Both examples show that the manipulation of the ownership structure is recognized by firms, governments, and international tribunals alike as a strategy to gain coverage under investment agreements. Moreover, while in both cases foreign ownership was added too late to prevent government policies that negatively affected the firms, foreign asset ownership can also serve a deterrent function. Even with foreign asset ownership, the domestic firm enjoys no direct improvements in property rights, because the protections of investment agreements do not apply to domestic firms: If the foreign firm files a claim for compensation, it is only compensated for the loss to its own share of the firm’s assets. It does not receive compensation for the loss to the domestic firm’s share of the assets, and it is under no obligation to share its compensation with the domestic firm. Even with a foreign partner, the domestic firm can only expect to gain compensation through the domestic property rights system. Partnerships with foreign firms instead carry indirect benefits for the domestic firm that stem not from compensation but from a reduced likelihood that the government implements damaging policies: If the foreign firm is covered by an investment agreement, the probability that the government

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<sup>7</sup>See the ICSID decision regarding jurisdiction in the claim brought by Mobil Corporation against Venezuela, <https://icsid.worldbank.org/apps/icsidweb/cases/pages/casedetail.aspx?CaseNo=ARB/07/27&tab=DOC>.

implements a damaging policy should decrease with foreign ownership.

This deterrent effect is driven by the government's inability to exclusively target the domestic firm's assets. Even if the government knows that a specific percentage of the firm's assets is held by a foreign partner, it cannot discriminate between assets held by the domestic and the foreign firm: Any reduction in the value of the domestic firm's assets also affects the value of the assets held by the foreign firm, because they are based on the same underlying business. If the damaging policy is implemented, the foreign firm can seek compensation through international arbitration. Because this is more likely to be successful than the domestic firm's attempts to obtain compensation domestically, foreign ownership reduces the overall probability that the government implements harmful policies.

We make no presumption that this effect eliminates government predation completely; however, foreign asset ownership should reduce instances of government predation. This deterrent effect of investment arbitration is a prominent mechanism in the literature to explain the effects of investment agreements. Bilateral investment treaties are commonly expected to increase foreign direct investment by granting investors access to arbitration and thereby reducing instances of expropriation in the first place (Rose-Ackerman and Tobin, 2005; Neumayer and Spess, 2005; Kerner and Lawrence, 2014). And while the details of arbitration at ICSID remain undisclosed in many cases, ICSID does publish its caseload, making it possible to identify the governments that have become subject to disputes (Wellhausen, 2016). The process of international arbitration may be enough to sour investors' perceptions of a government's investment climate, regardless of the outcome, and reduce future investment flows (Allee and Peinhardt, 2011). Concerns about reputation thus reinforce the costs of compensation and reduce the likelihood that a government implements damaging policies towards assets owned by foreign firms.

Several recent anecdotes of deterrence, often under the label 'regulatory chill,' are driven by the stipulations of investment agreements. Pelc (2017) documents the deterrent effects of

threatened disputes against Canadian tobacco and Indonesian mining regulations, and notes that governments may also be deterred by disputes levied against other governments, as in the case of New Zealand and Namibia. Despite this anecdotal evidence, deterrence has been difficult to validate more broadly. Measures of damaging policies are difficult to collect systematically, and the measures that do exist are often drawn from investment disputes, making them poorly suited to developing our understanding of whether investment agreements deter governments: many disputes never get arbitrated, clear-cut cases in particular are less likely to get arbitrated, and arbitration is only possible once an investment agreement is in place. In a recent exception, Arel-Bundock, Peinhardt and Pond (2017) overcome some of these limitations by looking at losses experienced by U.S. firms that led to insurance claims at OPIC, a U.S. government agency that provides investment insurance to U.S. firms. Most of these cases never resulted in arbitration, and many of the investments were not covered by investment agreements. They report that U.S. BITs are associated with fewer insurance claims. While this association still provides no causal evidence of deterrence, it does suggest that foreign assets that are covered by international law are subject to fewer damaging policies than assets that are not covered.

Moreover, there has been a growing perception by governments that existing investment treaties constrain their policy options – often based on experiences with litigation in the past, governments seem to increasingly shy away from new investment agreements (Poulsen, 2015; Wellhausen, 2016). For example, many leaders in Latin America have “viewed the spread of bilateral [investment] treaties as a threat to their countries’ sovereignty” (Salacuse, 2010, 434). The US–EU TTIP and the Canada–EU CETA agreements floundered due to the fear of constraints imposed by their investment chapters; governments are reluctant to agree to investment chapters, as the aim of litigation is “not only to obtain compensation but also to deter governments’ regulatory ambitions” (Pelc, 2017, 559). Hence, investment agreements plausibly have a deterrent effect, in particular in the perception of governments: deterrence is key for

theories identifying a constraining effect of investment agreements, it is corroborated by recent evidence, and it is echoed by government concerns about infringements on state sovereignty.

The implementation of damaging policies is not always a simple choice by a central policy-maker. In many cases, these policies are the outcome of complex political debates. But even then, international law can shape the political debate and tilt the decision towards compliance – an argument familiar from the literature on international law (Simmons, 2009; Chaudoin, 2016), but that also applies in the context of investment agreements. For instance, the Guatemalan government considered challenging a gold mine owned by Goldcorp, a Canadian mining company protected by access to international arbitration. Several domestic interest groups, as well as citizens, supported restrictions on the mining operation. Internal government documents show that the decision not to challenge the operation of the gold mine was shaped by the fear that Goldcorp could invoke ICSID arbitration to gain “access to international arbitration and subsequent claims of damages to the state.”<sup>8</sup> The threat of litigation shifted the debate in favor of those objecting to restrictions on the foreign firm.

For the domestic firm, seeking a foreign partner has a clear drawback. The domestic firm gives up some of its assets. The benefit is that, even if the domestic firm receives no direct protection or compensation from its foreign partners, it benefits indirectly, because joint asset ownership helps deter government predation. Put differently, domestic firms can trade property for property rights. This trade-off implies that ceding assets to foreign firms should be most attractive where domestic property rights are weak. Foreign ownership of the domestic firm’s assets deters government predation; where domestic property rights are weak, gaining this added protection is especially valuable.

This discussion assumes that a foreign partner is available, which often may not be the case. Nonetheless, partnerships that grant the domestic firm protection can be attractive to foreign

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<sup>8</sup>Quoted in The Guardian, “The obscure legal system that lets corporations sue countries,” June 10, 2015. Last accessed September 12, 2017.

firms as well. Because they are covered by international law, they do not have to be concerned as much with the domestic property rights environment (Neumayer and Spess, 2005). If deterrence is effective, they do not even have to get involved in international arbitration. And even if the foreign firms enters arbitration, which can be slow and costly, third-party financiers are increasingly willing to take potential arbitration awards as collateral for loans – not necessarily to cover the costs of litigation, but also to expand business operations while litigation is pending.<sup>9</sup> Consequently, the potential cost of litigation need not deter foreign firms from entering into these partnerships.

Moreover, the benefits of these partnerships to the foreign firm may compensate for any potential cost of litigation. Where property rights are weak, domestic financial markets tend to be underdeveloped (La Porta et al., 1997; Levine, 1999), implying above-average returns to foreign firms that are willing to enter these markets (Lucas, 1990; Wurgler, 2000). Firms that benefit from protections through international law face effectively less risk while enjoying, from their perspective, elevated returns on their investment.

Additionally, the foreign firm may have wanted to expand into the domestic market already, and the domestic partner can provide the foreign firm with access to valuable assets. Partnering with domestic firms may grant the foreign firm access to natural resources, infrastructure, and knowledge of domestic markets that it otherwise would lack (Markusen, 1995; Henisz, 2000). Having access to international law then provides it with an advantage over competitors, both because it enjoys protection for its own assets and because this access makes it an attractive partner to domestic firms.<sup>10</sup> For the foreign firm, the primary purpose of the partnership need not, and likely is not, to grant the domestic firm protection. Indeed, as long as the presence of the foreign firm increases the expected cost to the government of implementing damaging policies, the partnership serves its purpose from the perspective of the domestic firm. This is

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<sup>9</sup>The Guardian, “The obscure legal system that lets corporations sue countries,” June 10, 2015. Last accessed September 12, 2017.

<sup>10</sup>We show later that foreign firms receive larger ownership shares where domestic property rights are weak.



not to say that all domestic firms have numerous foreign partners with access to arbitration available to them. While all domestic firms are certainly not attractive partners to foreign firms, some plausibly are.

The logic of this argument thus applies to a specific, but potentially substantial set of domestic firms. Where property rights are weak, even politically connected domestic firms have to be concerned about maintaining their current privileges into the future. Domestic firms with attributes – such as knowledge of local markets, access to natural resources, or ownership of key infrastructure – that are valuable to foreign firms provide foreign firms with an incentive to enter into these partnerships as long as they are covered by international law. Notably, these conditions are plausibly met for many large domestic firms where the threat of government predation is particularly acute: those with fixed capital investments that are specific to the local market.

In sum, we expect domestic firms to seek foreign partners that are covered by international law in order to deter government predation. Because ceding assets to foreign firms is costly, this trade-off is most attractive where domestic property rights are weak, as summarized in the following proposition.

**Proposition 1.** *Domestic firms are more likely to seek out foreign partners that are covered by an investment agreement as domestic property rights decrease.*

We emphasize that not all foreign firms are equally attractive for these partnerships: to gain protection, the foreign firm needs to be covered by international law and have access to arbitration. If the foreign firm is not covered by an investment agreement, it must be concerned about its own investment to a larger extent where property rights are weak, plausibly deterring investments (Li and Resnick, 2003); and the domestic firm gains no protection under international law from partnering with the foreign firm, such that there is no incentive for the domestic firm to form a partnership for protection against its government.

This emphasis on the role of international law sets our theory apart from arguments about the influence of foreign firms over host governments, either because they are backed by powerful home governments (Maurer, 2013) or because their continued investment is valuable to the host economy (Moran, 1973). Backing by the home government is firm-specific and subject to political uncertainties in the foreign firm's home country. The economic importance to the host economy is likewise firm-specific and subject to fluctuations. In contrast, because international law provides a rule-based system of property rights, any foreign firm covered by an investment agreement has credible access to arbitration.

The following proposition highlights the importance of the foreign firm's access to international law. Ceding control to uncovered partners yields no benefit to the domestic firm; it only loses parts of its profits to the foreign firm. Hence, the presence of an investment agreement, which creates the segmentation of property rights between domestic and foreign firms, is necessary for weaker property rights to increase partnerships with foreign firms. The same argument applies to domestic partnerships: ceding control to domestic partners does not deter government predation. An uncovered partner does not reduce the government's appetite for predation, and there is no reason for the domestic firm to cede a share of its assets to an uncovered partner.

**Proposition 2.** *Partnerships between domestic firms and firms that lack cover by an investment agreement should not be more likely as domestic property rights decrease.*

Before turning to a systematic evaluation of Propositions 1 and 2, we highlight two additional implications of our theory. First, our argument implies a notable upside for the foreign firm: the domestic firm should have less bargaining leverage towards the foreign firm where property rights are weak, because it needs the protection the foreign ownership implies. If this is the case, foreign firms should be able to obtain relatively more attractive deals in foreign markets where property rights are weak than where property rights are strong. Put differently, covered foreign firms secure relatively better business deals abroad, thanks to the investment

agreements negotiated and backed by their home governments. This suggests a novel effect of the global expansion of the investment protection regime. Investment agreements, pursued especially by wealthy developed countries since the 1950s, provide protection to investors from these countries. To investors, this protection can be valuable in itself, because it protects their assets. But it also awards them a comparative advantage in their investment relationships relative to firms from other countries. In addition to contributing new capital or technology, they enjoy property rights that make them valuable partners. Ceding ownership of their assets to foreign firms allows domestic firms to ‘import’ property rights, and international investment law becomes a source of comparative advantage in this trade.

Second, partnerships between domestic and foreign firms partially overcome the segmentation of property rights between domestic firms and foreign firms that is created by international investment agreements: domestic firms can benefit, albeit indirectly, from the protections afforded to foreign firms. Finding foreign partners may provide a suitable substitute for domestic property rights without the need to move assets abroad, and, indeed, causing an inflow of foreign capital. This also implies that firms, and owners of domestic assets, may have a positive attitude towards foreign asset ownership, and openness to international capital more generally, if this ownership comes with better protections against capricious government actions. The theory offers a novel source of preferences towards global capital that is distinct from existing explanations, most notably distributional concerns.

## **Empirical results**

If international law provides an umbrella of property rights to foreign firms, domestic firms should be most eager to get under this umbrella by ceding assets to foreign firms where domestic property rights are weak. This pattern should be confined to foreign firms that have access to international law. To evaluate the propositions, we leverage cross-country variation

in domestic property rights and financial linkages between domestic and foreign firms, which are compiled from firm-level data on international financial relationships, and we leverage variation in the access of firms to international law.

We present two sets of results. We first discuss results that focus on foreign investors covered by international law to establish that weaker property rights are associated with more partnerships with covered foreign firms, consistent with Proposition 1. We then distinguish between covered and uncovered foreign firms as a function of membership in investment agreements, and we show that weak property rights only increase partnerships with foreign firms that have access to international arbitration through investment agreements, consistent with Proposition 2. These findings establish that our results are plausibly explained by the access of foreign firms to international law and the desire of domestic firms to take advantage of this access.

For our first set of results, we construct a sample of non-OECD countries that have, in the respective year, BITs or trade agreements with investment chapters with the U.S. in force; jointly, we refer to both as investment agreements in the following.<sup>11</sup> All of these agreements include protections for foreign investors. In particular, they provide U.S. investors with access to arbitration at ICSID. Thus, we only include countries where foreign investors are protected by international law. Where foreign investors are not protected, domestic firms cannot gain protection through partnerships with them. Moreover, where foreign investors are protected by an investment agreement, domestic property rights should be less relevant for their investment decision, given that protection provided by investment agreements tends to substitute for weak domestic property rights and often surpasses those in terms of breadth (Ginsburg, 2005; Neumayer and Spess, 2005).

We focus on investment agreements with the U.S. for several reasons. First, the U.S. has the

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<sup>11</sup>Using a sample of non-OECD countries as investment receiving countries is consistent with the seminal literature (see Kerner 2009 and citations therein). Notably, this excludes Mexico. Results using instead a sample of non-high-income countries, following the IMF's definition of advanced economies, which includes Mexico, are similar and reported in the appendix.

largest and deepest financial market and, because of this liquidity, is a likely source of foreign partners. Second, by focusing on the U.S., we implicitly control for country-specific attributes of foreign firms and markets without introducing heterogeneous country pairs. Third, because U.S. firms are subject to U.S. reporting standards, we obtain a more representative sample than if we included firms from several home countries in the same sample. Finally, the U.S. has been the investor home country with the largest number of ICSID filings in the past (Wellhausen, 2016), suggesting that partnership with U.S. firms is valuable to foreign firms for purposes of gaining protection.

Our dependent variable measures mergers and acquisitions (M&As) between domestic firms and U.S. firms announced in any given year. We collect data from the Thomson One database, which provides firm-specific investment data, and aggregate it to the country-year level. Through an M&A, a U.S. firm obtains a direct managing interest in a foreign firm. Thomson One provides detailed data on each project, such as the name, location, and industry of the acquiring and target company. We collect data on all M&As where a U.S. firm acquired parts or all of a foreign firm between 1980 and 2012 (excluding cases where the U.S. firm acquired all of a domestic firm does not alter our results). We do not include M&As where a domestic firm acquired a U.S. firm, and we do not include any M&As that are only between domestic firms – every M&A in the sample is a cross-border transaction involving a U.S. firm as the acquiring entity. This directionality prevents our variable from picking up domestic firms moving assets out of the reach of the domestic government by investing abroad, which would be another plausible response to weak domestic property rights. In our sample, the variable ranges from 1 to 65 M&As per country-year, with an average of about 4 M&As.

Because the M&A variable counts the number of specific projects involving domestic firms, it provides a direct measure of how many domestic firms seek to gain foreign partners. This provides, for our purposes, distinct advantages over commonly used variables such as the overall stock or inflow of foreign direct investments. Overall direct investment data, for instance,

include greenfield investments (which occur without participation of domestic firms and hence are irrelevant for our argument). And if a large amount of direct investment is concentrated in a small number of projects, it protects only a small number of domestic firms.

The drawback is that there is no guarantee that the Thomson One data are complete. Just as measurement error is likely present in foreign direct investment positions, it is likely that some M&As are missing. However, the Thomson One data base is usually considered the most comprehensive source of firm activities (Tingley et al., 2015; Pandya and Leblang, 2017). By focusing on activities that involve U.S. firms, we further hope to reduce the number of missing activities: we hold constant the reporting standards on the U.S. side. Publicly listed companies in the U.S. have to report to the Securities and Exchange Commission, and the largest firms – those that tend to own foreign assets – frequently are publicly listed.

To the extent that undercounting of M&A activities is systematically related to our variable of interest, it likely works against our proposition. Countries with stronger property rights and more effective legal systems should have stricter recording standards and produce better economic statistics, resulting in a larger number of (observed) M&As where property rights are strong. In additional results below, we report that our results also hold when controlling for differences in the capacity of countries to record and process economic statistics, which accounts for bias arising from differences in reporting standards.

For the measure of property rights protection, we draw on the rule of law variable from the Worldwide Governance Indicators (Kaufmann, Kraay and Mastruzzi, 2010), which is commonly used in the literature (e.g., Oliva and Rivera-Batiz 2002; Li and Resnick 2003; Daude and Stein 2007). It combines several indicators of confidence in the rules of a society and the extent to which those rules are abided by – such as the functioning of the judiciary and contract enforcement. The variable is obtained from the Quality of Government dataset and normalized from zero to one (Teorell et al., 2016). Contrary to a popular alternative, the International Country Risk Guide quality of governance variable, the variable focuses on domestic

property rights, not the perceptions of international investors. Because we are concerned with the incentives of domestic firms to seek out foreign partners, rather than vice versa, the former variable is preferable for evaluating our theory.

All models include a common set of control variables. First, democratic institutions tend to be associated with better property rights and with the ability of governments to attract foreign

1996 and 2012.<sup>12</sup> A list of the countries and summary statistics are available in the online appendix. Because our dependent variables are counts, but never have a value of zero, we estimate zero-truncated negative binomial models, which are an extension of negative binomial models.<sup>13</sup> To account for the non-independence of observations within countries and the slow temporal changes on the variable on domestic property rights, which would otherwise inflate t-statistics and deflate p-values, we cluster standard errors by country, which addresses such ‘repeated’ measurements (Moulton, 1986). At the same time, the slow movement of the property rights variable implies that our results are mostly explained by cross-country differences, not by within-country variation over time, and it is possible that unobserved country characteristics account for some of our results.<sup>14</sup>

Before turning to the empirical results, we note that the set of countries with investment agreements is not a random sample. Membership in investment agreements is plausibly driven by the host government’s expectations of the effects of these agreements on attracting investments (see, e.g., Kerner 2009). Consequently, the self-selection of countries into membership in these agreements is an important concern in the literature on the effects of investment agreements, and it is a concern that remains largely unresolved (Neumayer and Spess, 2005).<sup>15</sup> However, our main proposition is not about the effects of investment agreements. Rather, for countries that have joined investment agreements, we expect that weaker property rights encourage more domestic firms to seek foreign partners.

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<sup>12</sup>The property rights variable is not coded for 1997, 1999, 2001; filling in missing values with the average of the neighboring years (that is, replacing a missing value for 1997 with the average of a country’s property rights in 1996 and 1998) does not alter the substantive conclusions.

<sup>13</sup>We obtain larger substantive effects and often smaller standard errors when estimating standard negative binomial models (reported in the appendix).

<sup>14</sup>Estimating fixed effects models yields a negative association between property rights and partnerships with foreign firms, but the coefficient on domestic property rights is not statistically significant at conventional levels in these models; we report these in the appendix. The coefficient remains negative and statistically significant with random effects as well as in a hierarchical model.

<sup>15</sup>For instance, a popular instrumental variable in this literature are investment agreements signed by neighbors. Yet, as Betz, Cook and Hollenbach (2017) show, such spatial instruments are inherently endogenous, rendering them invalid.



Just as importantly, there is no indication that countries differ significantly or substantively in terms of their domestic property rights environments depending on whether they signed investment agreements with the U.S. The average of the property rights variable is .502 for countries without investment agreements and .464 for countries in the sample with investment agreements. This difference is small and, with a  $p$ -value of .342, not statistically significant. The overall distribution of the domestic property rights variable across the two samples is, likewise, not significantly different. To evaluate this systematically, we implement the test statistic of Brown and Forsythe (1974), which is based on absolute deviations from the median for countries with and without investment agreements; to account for the non-independence of observations within countries, we follow Iachine, Petersen and Kyvik (2010) and use a sandwich estimator. The distribution of the property rights variable is not statistically significantly different in the two samples.

Nonetheless, the self-selection into investment agreements is potentially problematic if countries with weaker property rights sign investment agreements with the U.S. in the expectation of attracting investments, while countries with stronger property rights sign investment agreements for non-economic reasons – in particular, because of their military alignment with the U.S. In this case, higher property rights could result in fewer partnerships with foreign firms, but not for the reasons identified in our theory. The association would be driven by different motivations for signing investment agreements. Yet, there is little reason, theoretically or empirically, to suspect that this is the case. Indeed, logged U.S. military aid, obtained from USAID, is not significantly correlated with property rights in our sample; and as we show below, our results are robust to controlling for U.S. military aid in the empirical models.

This is not to say that membership in investment agreements is exogenous; self-selection clearly is a concern. But we find little evidence that self-selection into investment agreements is systematically related to our main variable of interest, nor do we find evidence that this self-selection presents an alternative explanation of a negative association between property rights

and partnerships with foreign firms.

**Results.** Table 1 presents the main results. The first column reports our baseline model with the set of control variables discussed above. As expected, an increase in property rights is associated with fewer partnerships between foreign and domestic firms. The coefficient is statistically significant at the five percent level and substantively large. Moving from the 10th to the 90th percentile on the property rights variable reduces the number of M&As by over 50 percent, from 5.6 to 2.6. In terms of countries in the sample, this shift is similar to the difference between Ecuador (with weak property rights) and Uruguay (with strong property rights) in 2007. Similarly, a one standard deviation decrease in property rights is associated with an increase in partnerships with foreign firms of about 23 percent.

The results support the argument that domestic firms attempt to tap into property rights provided to foreign investors by ceding assets to covered foreign investors. As property rights deteriorate, domestic firms increase their involvement with U.S. firms through M&As, ceding some control over their own operations in exchange for their partner's coverage under international law. The results also highlight the importance of taking into account the domestic firm explicitly. As in Li and Resnick (2003), who focus on the motivations of foreign investors mostly in the context of greenfield investments, the effect of property rights has the opposite sign from the effect of democratic institutions. Unlike Li and Resnick (2003), however, who argue that stronger property rights encourage foreign investments while democratic institutions deter them, we find that the opposite applies to domestic firms: weaker property rights and more democratic institutions encourage partnerships with foreign firms. These differences underscore how domestic-foreign partnerships may be formed for very different reasons than greenfield investment by multinational corporations.

The remaining columns in Table 1 introduce additional control variables to account for potential sources of bias; additional robustness checks are relegated to the appendix and discussed below. First, M&A activity is frequently explained by global value chains and therefore

**Table 1: Property rights and domestic-foreign partnerships**

	M&As between domestic and U.S. firms					
	(1)	(2)	(3)	(4)	(5)	(6)
Property rights	-2.03** (.027)	-2.18*** (.007)	-2.03** (.040)	-2.27** (.024)	-1.83*** (.007)	-2.29*** (.007)
Democracy	.95*** (.000)	1.02*** (.000)	.95*** (.000)	1.02*** (.000)	1.10*** (.000)	.94*** (.000)
GDP	2.14*** (.000)	1.92*** (.000)	2.14*** (.000)	2.13*** (.000)	2.00*** (.000)	1.96*** (.000)
GDP per capita	-.22*** (.002)	-.22*** (.001)	-.22*** (.004)	-.20*** (.001)	-.21*** (.006)	-.20*** (.000)
Population	-1.40*** (.000)	-1.42*** (.000)	-1.39*** (.000)	-1.43*** (.000)	-1.43*** (.000)	-1.37*** (.000)
Capital account	.004 (.216)	.003 (.339)	.004 (.252)	.003 (.459)	.003 (.370)	.009** (.021)
US distance	.45 (.139)	.89** (.029)	.44 (.167)	.47 (.119)	.73* (.063)	.80*** (.005)
Domestic credit	.16 (.217)	.21* (.060)	.16 (.193)	.16 (.234)	.28 (.124)	.12 (.391)
Bilateral trade openness		.24 (.151)			.26 (.185)	.16 (.201)
Economic complexity			.020 (.928)			
US military aid				.043 (.685)		
Statistical capacity					-.012 (.514)	
Constant	-31.3*** (.000)	-32.7*** (.000)	-31.3*** (.000)	-31.2*** (.000)	-34.2*** (.000)	-33.1*** (.000)
Year FE	yes	yes	yes	yes	yes	yes
Number Obs.	192	188	189	189	125	326
Number Countries	33	33	32	33	29	37

Coefficient estimates and  $p$ -values. Columns (1)-(5): Zero-truncated negative binomial regression. Column (6): Negative binomial regression. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.

trade linkages. We thus include a variable for bilateral trade between the U.S. and each country, reported in column (2). The precision of the coefficient estimate increases, and the substantive size of the effect remains similar.

Second, we account for a country's economic structure by including the index of economic complexity (Hausmann et al., 2014). More developed and complex economies have more economic activity and more linkages with the international economy, creating more opportunities for M&As. Economic complexity also tends to be associated with more effective domestic institutions. The results, reported in column (3), remain robust to including this control variable.

Third, if countries with higher property rights sign investment agreements for strategic rather than economic reasons, we could observe less M&A activity in these countries. We account for dependence on the U.S. by including the log of military aid received from the U.S. (data from USAID). The negative association between property rights and partnerships remains, as reported in column (4). In the appendix, we report that the results are also robust to controlling for military aid as a percentage of GDP and the bilateral direct investment position with the U.S. (data from the Bureau of Economic Analysis). Including this latter variable also takes into account the more general appetite by U.S. firms for investments in the domestic economy (which need not involve domestic firms in any way), which differentiates the demand by foreign firms for investments from the desire by domestic firms to seek foreign partners.

Fourth, countries differ systematically in their statistical capacity and therefore data quality. It is plausible that statistical capacity and property rights are correlated. While GDP per capita may account for some of these differences, we control for a country's capacity to compile economic statistics in a timely manner explicitly, using data on statistical capacity from the International Monetary Fund. While including the variable reduces our sample size substantially (both in terms of the number of countries and time periods), the negative and statistically significant coefficient for domestic property rights remains, as we report in column (5).

Finally, our main models included only country-years where at least one M&A was reported.

Observations with no data may be country-years with no newly formed investment relations, or they may be country-years where partnerships occurred but were not reported. In column (6), we take missing data as an indication that no M&A was formed and recode the dependent variable to zero for observations where no M&A has been reported. This change increases our sample to up to 37 countries, four of which never reported any M&A between a domestic and a U.S. firm. Because the dependent variable now includes zeros, we estimate standard negative binomial models. The results are robust to this change, and the marginal effect increases in size: moving from the 10th to the 90th percentile of the domestic property rights variable is associated with a decrease in M&As of almost 60 percent, from 4.0 to 1.7.<sup>16</sup>

The appendix provides several additional robustness checks which account, among others, for participation in International Monetary Fund programs, which tend to couple privatization demands with reforms to the property rights regime; for the production of natural resources, which tends to be capital-intensive and located in countries with weak property rights; for the exchange rate level and regime, which matter for attracting foreign investors; and we remove M&As involving the privatization of state-owned companies from the sample, which may still enjoy privileged access to the government. The results are robust to these changes.

### **The role of international law: uncovered vs covered foreign firms**

The previous results establish that weaker property rights encourage partnerships between domestic and foreign firms that are covered by investment agreements. We now focus on the role of international law. If the results are explained by protections of foreign firms under investment agreements and their access to arbitration, then the negative association between property rights and partnerships with U.S. firms should be confined to countries where U.S. investors are protected – where no investment agreement exists, seeking out U.S. partners

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<sup>16</sup>In the appendix, we report that similar results obtain when estimating a zero-inflated negative binomial model, which allows for a separate process to contribute observations with a value of zero. The inflation equation includes a constant and the property rights variable.

cannot grant domestic firms protection.

We therefore extend the sample to countries without U.S. investment agreements, which increases the sample to 71 countries, and interact the variable for participation in a U.S. investment agreement with the other variables in the model.<sup>17</sup> The model remains unchanged otherwise and includes year fixed effects. Figure 1 reports the marginal effect together with the 95 percent confidence interval of a one unit change in the explanatory variables; for the property rights variable the figure reports the change when moving from the 10th to the 90th percentile. Because of the interaction, the figure reports two marginal effects for each explanatory variable: We indicate with solid circles and in darker grey the marginal effect where U.S. investors are covered by international law, and with hollow circles and lighter grey the marginal effect where U.S. investors are not covered by international law.

As anticipated by the theory, weak property rights are associated with increased financial linkages only when the investment partner is covered by international investment law. Where this is not the case, the opposite relationship holds. The effects are in both cases statistically significantly different from zero at the five percent level. Moreover, the difference between the two effects is statistically significant as well (the  $p$ -value on the interaction term is .000), reinforcing the qualitative difference between the two effects.

Plausibly, the results in the absence of investment agreements reflect that foreign investors shy away from countries with weak property rights when they lack access to alternative forms of property right protection (see Neumayer and Spess 2005; Pandya 2016). That the effect of property rights depends on participation in investment agreements also rules out several alternative explanations: that foreign firms choose M&As over greenfield investments where property rights are weak in order to navigate corrupt political systems (Henisz, 2000); that for-

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<sup>17</sup>The decision of whether to include the interaction terms on the explanatory variables affects our substantive interpretation of the marginal effect of the property rights variable. Because the model that interacts all independent variables nests a model that interacts only the variable for domestic property rights, we prefer the former.

foreign firms choose M&As over contracting with domestic firms in environments with weak property rights because they are worried about technology theft (Antras, Desai and Foley, 2009); or that domestic firms seek U.S. partners because of the U.S. government's extraordinary will (combined with economic and political power) to defend private investments abroad (Moran, 1973; Maurer, 2013). Figure 1 shows that these explanations, which do not depend on the presence of an investment agreement, are unlikely to account for the results: the negative association between property rights and M&A activity is confined to countries with investment agreements.

Figure 1 further shows that the effects of several other variables differ in the presence of a U.S. investment agreement. Investment agreements appear to reinforce differences in market size in attracting foreign investors, as indicated by the larger effect for GDP. Moreover, the results indicate a noticeable difference in the effects of geographic distance. Countries farther from the U.S. receive less foreign investment in the absence of an investment agreement. However, the presence of investment agreements appears to compensate for this deterrent effect of distance. Finally, the results provide further evidence to suggest that a lack of domestic credit is not driving the results. An increase in domestic credit is associated with more M&As in countries without investment agreements.

Table 2 reports several additional results that amount to placebo tests. First, our theory emphasizes the importance of credible access of the foreign partner to arbitration under international law. The U.S. signed several agreements that declare a common desire to foster economic exchange between the U.S. and its partner country, but that lack any clear protections or stipulations for U.S. investors and provide no access to arbitration. The negative association between property rights and M&As should disappear where international law provides no such access. To identify these agreements, we draw on UNCTAD for a list of all investment agreements involving the U.S. and then determined from the agreement text whether investors have access to ICSID arbitration under the agreement. The majority of these agreements are

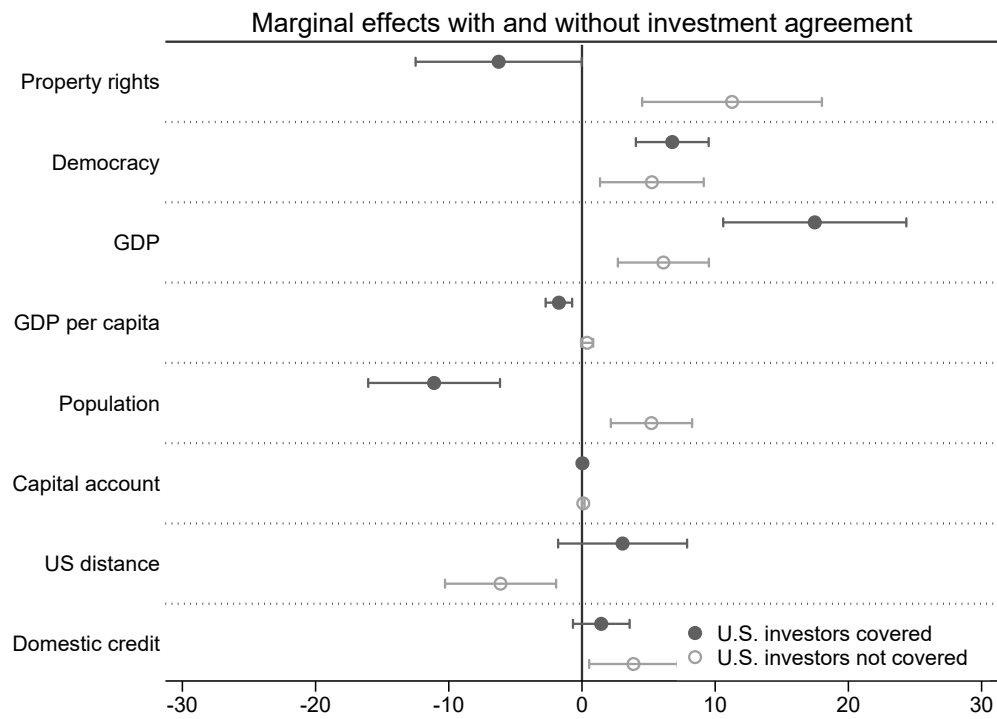


Figure 1: Marginal effects and 95 percent confidence intervals when U.S. investors are covered by international law (solid circles, darker grey) and when U.S. investors are not covered by international law (hollow circles, lighter grey). Based on 71 countries. Full results reported in the appendix.



investment framework agreements, which follow a common template.

As expected, the negative association between property rights and M&As disappears in this sample, as shown in columns (1) through (3) of Table 2. Instead, stronger property rights are associated with more M&As. These results corroborate that the specific protections of international law are crucial for explaining the negative association between property rights and partnerships with foreign firms – foreign firms that lack credible access to international law are not useful partners to domestic firms for gaining protection.

Second, we replace the dependent variable with domestic M&As. M&As between firms from the same country cannot grant additional protection through international law, and the negative association between domestic property rights and M&As should disappear. We obtain the number of domestic M&As from Thomson One. The resulting variable ranges from 1 to 205, with an average of about 14 domestic M&As. The sample is identical to our main sample and includes only countries with investment agreements with the U.S.

The results, reported in columns (4) through (6) of Table 2, show that domestic property rights have little effect on domestic M&As. The effect of domestic property rights is positive and statistically indistinguishable from zero. Not surprisingly, one of the strongest determinants of domestic M&As is the development of the domestic financial market, as indicated by the variable on domestic credit. When excluding this variable, the coefficient on property rights increases in size and becomes statistically significant at the five percent level.

In sum, the results lend additional support to our theory, which emphasizes differential access to international law. It is not the case that M&As in general are more popular in countries with weaker property rights. Instead, weaker property rights drive partnerships only with those foreign investors that have access to international law.

**Table 2: Property rights and access to arbitration**

	Agreements without ICSID			Domestic M&As		
	(1)	(2)	(3)	(4)	(5)	(6)
Property rights	6.25*** (.000)	5.81*** (.000)	5.53*** (.000)	.86 (.449)	.77 (.504)	.75 (.478)
Democracy	.69** (.035)	.75** (.016)	.66*** (.003)	1.18*** (.000)	1.15*** (.000)	.93*** (.000)
GDP	.37*** (.003)	.19 (.147)	.37*** (.001)	2.13*** (.000)	2.15*** (.000)	1.99*** (.000)
GDP per capita	-.0021 (.863)	-.014 (.331)	-.014 (.220)	-.29*** (.000)	-.29*** (.000)	-.31*** (.000)
Population	.78*** (.000)	.62*** (.000)	.67*** (.000)	-1.35*** (.002)	-1.36*** (.002)	-1.16*** (.000)
Capital account	.025*** (.000)	.020*** (.002)	.018*** (.000)	.0042 (.302)	.0043 (.301)	.0058 (.150)
US distance	-1.16*** (.000)	-1.26*** (.000)	-1.37*** (.000)	1.81*** (.000)	1.81*** (.000)	1.50*** (.000)
Domestic credit	.29 (.156)	.20 (.199)	.11 (.369)	.42*** (.007)	.41** (.012)	.29* (.069)
Bilateral trade openness		.34*** (.000)			-.021 (.892)	
Economic complexity			.55*** (.000)			.58*** (.001)
Constant	-16.8*** (.000)	-13.2*** (.003)	-12.0*** (.000)	-43.3*** (.000)	-43.3*** (.000)	-39.8*** (.000)
Year FE	yes	yes	yes	yes	yes	yes
Number Obs.	94	90	92	249	241	244
Number Countries	18	16	16	34	33	32

Truncated negative binomial regression, coefficient estimates and *p*-values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Columns (1-3): Countries with U.S. investment framework agreements or other investment agreements that do not provide ICSID access. Columns (4-6): Countries with U.S. BITs and trade agreements with investment chapters.

### **Additional evidence: firm-level data on foreign ownership shares**

Governments are more effectively deterred where foreign ownership shares are larger, because this implies that a larger portion of the damages is subject to compensation and because larger foreign ownership shares increase the stakes of the foreign partner. Additionally, a larger foreign ownership share reflects the foreign firm's larger bargaining leverage, which it gains from its access to international law. Consequently, as domestic property rights deteriorate, domestic firms should grant larger ownership shares to foreign firms. To assess whether this is the case, we leverage the firm-specific data from Thomson One, which for some M&As provides the foreign ownership share after the transaction. We emphasize that these data are incomplete; our in-sample missing values for ownership share are about 30% of all projects.

In the appendix, we report results from a beta regression model, estimated via maximum likelihood, given that the dependent variable is a ratio and therefore bounded between zero and one. The beta distribution does not accommodate values at the boundary – a foreign ownership share of 100% – which is a strength in this case: firms selling all of their assets are not finding friends, but exiting the market. As before, we include year fixed effects and cluster standard errors by country. The results corroborate the argument: domestic firms give up larger ownership shares where property rights are weak. Substantively, an improvement in property rights from the 10th to the 90th percentile is associated with a reduction in the foreign ownership share from 52% to 40%.

### **Additional evidence: bond and equity issuings**

Domestic firms can find foreign partners through M&As. Alternatively, by issuing bonds or equity, a domestic firm can link its assets to those of a foreign firm that is acquiring these assets. U.S. firms holding financial instruments are explicitly covered under U.S. investment agreements. Issuing bond or equity therefore allows domestic firms to obtain indirect coverage

from foreign firms, and issuings should follow the same pattern as M&As.

We obtain data on the number of bond and equity issuings by domestic firms from Thomson One. These bond and equity issues cover a variety of assets, such as mortgage-backed securities, debt instruments, and stock issues. We exclude any issues by government agencies, which do not fall into the purview of our theory. The distinct advantage of these data is that the existing literature usually focuses on political risk faced by foreign investors in the context of foreign direct investment (and, by implication, M&As). This is not the case for bond and stock holdings – which are more liquid assets and less subject to political risk (Vernon, 1971; Frieden, 1994; Ahlquist, 2006; Kerner and Lawrence, 2014). Accordingly, perceptions of political risk on behalf of foreign firms, derived from domestic property rights, are unlikely to drive the results. But from the perspective of domestic firms, attracting liquid investment from foreign firms (in the form of bond or equity purchases) can be just as attractive as illiquid investment (in the form of direct investment such as M&As). Both provide indirect cover under common stipulations in international investment law.

Yet, these data also have notable limitations. Contrary to the M&A data, we cannot determine who purchased these assets; we can only identify the issuing firm. It is plausible that U.S. investors acquire at least a portion of these assets, given the depth and breadth of the U.S. financial market and given that the sample only includes countries with investment agreements with the U.S., but we cannot guarantee that this is the case. At the same time, we have no strong theoretical reasons to suspect systematic bias in who acquires these assets that would result in a negative association between property rights and bond and equity issues.

Another concern with bond and equity issues is that the literature on corporate governance proposes an alternative explanation for why weak property rights correlate with the cross-listing of stocks on foreign markets. Concerned about expropriation by controlling shareholders, minority shareholders are hesitant to invest in equities where minority shareholder protections are weak. In an attempt to drive up equity prices, firms therefore cross-list equity

in markets with stronger shareholder protections (Coffee, 2002; Doidge, 2004; Siegel, 2005). The motivation of domestic firms therefore differs from our argument. While we focus on the role of international law in providing protection against government predation, the bonding literature focuses on the role of a foreign country's securities law in providing protection against controlling shareholders. However, because property rights and minority shareholder protections are plausibly correlated, cross-listing may be more common where property rights are weak. To address this concern, we include a control for minority shareholder protections, obtained from the World Bank's Doing Business database. The data on shareholder protections are not available for years before 2006. Considering the few changes in the series from 2006 to 2012, we use the 2006 data for earlier years. In our sample, the variable on shareholder protections is negatively correlated with domestic property rights, which allays concerns that the omission of this variable is accounting for a negative effect of property rights.

With the variable on equity and bond issues in place of M&As, we replicate the main models in the sample of countries with U.S. investment agreements; the results are reported in the appendix. As expected, weaker property rights are associated with more bond and equity issues. Moving from the 10th percentile of the property rights variable to the 90th percentile results in a reduction in bond and equity issues from 30 to 9.7. The variable on minority shareholder protections, in contrast, has a positive and statistically insignificant effect.

## **Conclusion**

This paper demonstrates how firms, in countries with weak property rights protection, may form international partnerships to deter government predation. Governments will be deterred from taking actions that reduce the profits of domestic firms if they know that the firm is jointly owned with a foreign firm that has access to – and will likely be awarded compensation by – an international investment tribunal. Evidence from firm activities in countries with investment

agreements with the United States is consistent with the theory.

By demonstrating how domestic firms may gain protection against their government through international partnerships, this paper uncovers a previously unexplored implication of the international regime for the protection of foreign investments. The theory underscores the importance of considering domestic and international politics simultaneously. If international and domestic law provide different standards, firms will try to leverage these differences to their benefit. Domestic firms may be able to gain access to better property rights standards than their domestic environment provides. As in the literature on the race to the bottom, this dynamic provides an example of how globalization erodes different standards across territorial boundaries. Unlike the race to the bottom, this leveling of standards occurs without the threat of disinvestment.

The paper has several broader implications. First, parts of the literature have noted that international law has not contributed much to the improvement of domestic institutions – in particular, investment agreements seem to have little impact on improving the domestic business environment (Tobin and Rose-Ackerman, 2003). We offer a potential explanation for this pattern. Because domestic firms can escape weak domestic property rights by forming partnerships with foreign firms, they do not have to push for improvements of the domestic property rights regime. This has another, perhaps counterintuitive, implication: rather than constrain them, foreign asset ownership and investment agreements can help insulate governments from political demands. The provision of property rights at the international level, spread through investment treaties and international financial relationships, helps protect some firms from government predation. This protection may reduce demand from domestic firms for property rights improvements. If so, the protection comes at the cost of delaying reforms that would improve the institutional environment in these countries on a broader scale.

Second, international law and the structure of international financial markets perpetuate the influence of already powerful countries. Domestic firms in countries with weak property

rights seek out foreign partners that provide protection from government predation. These domestic firms offer foreign partners lucrative investment opportunities, not because their capital is necessary but because their protection is needed. This dynamic perpetuates the market power and influence of countries like the United States, which combine a large number of investment agreements with deep financial markets. This combination may give firms from the U.S. a competitive edge when trying to expand abroad; in turn, it reinforces the global influence of the U.S. This dynamic continues a pattern. Historically, U.S. governments have demonstrated an unusual willingness to defend the rights of private investors abroad, especially in Latin America and the Caribbean (Maurer, 2013). With international investment agreements, this pattern of privileged protections continues, albeit in a much more legalized fashion.

Finally, by developing a theory based on ownership structure and more specifically on partnerships between firms, the paper adds nuance to a new field in the study of political economy. A large literature in economics and political science has addressed differences in the ownership structure of firms as a means to internalize externalities and information asymmetries (Coase, 1960; Dunning, 1981; Henisz, 2000; Antras, Desai and Foley, 2009). We considered a different dimension of ownership structure: the choice of partners from different jurisdictions, which is driven by the desire to leverage differences in the protections afforded by international law. This mechanism complements a nascent literature that has begun to examine differences in tax policies as a driver of subsidiary creation across countries (Desai, Foley and Hines, 2006; Arel-Bundock, 2017). Diversifying the ownership structure across jurisdictions is feasible for many firms; the only necessities seem to be an attorney and a post office box.

It is plausible that firms, especially multinational corporations, extend their choices of subsidiary location and investment partners also to other domains in order to leverage differences in policies or access to international law – such as membership in trade agreements, a government’s willingness to defend exporting opportunities through trade disputes, or membership in prominent collective security organizations. Thus, countries may gain a comparative ad-

vantage not only from their factor endowment, domestic institutions, or contract enforcement (Heckscher et al., 1991; Sokoloff and Engerman, 2000; Cai and Treisman, 2005; Nunn, 2007), but also from their membership in international agreements. Understanding the mechanisms and the incentives behind these firm strategies emerges as a promising area for future research.



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## A Online appendix: formal model

### Set-up

There are two actors in the model: a domestic firm and its government. The sequence of play is as follows:

1. The domestic firm decides whether and how much ownership to grant to a foreign partner,  $f \in [0, 1]$ .
2. The government decides whether to implement the damaging policy, where  $\sigma \in [0, 1]$  captures the share of assets lost due to the policy.
3. If the government implements the damaging policy, the domestic and the foreign firm receive compensation with probabilities  $\rho$  and  $\iota$ , respectively.

The domestic firm has assets worth  $K$ . These assets produce a rate of return  $r \in (0, 1]$ . We normalize the firm's assets to one ( $K = 1$ ), such that the domestic firm's profits are simply  $r$ . If the government implements the damaging policy, it reduces the domestic firm's profits by some fraction  $\sigma \in [0, 1]$ , with  $1 - \sigma$  representing the remaining fraction of the firm's profits. If the government does not implement the damaging policy, the firm's profits are unaffected.

The government's benefit from implementing the damaging policy is  $\mu$ , while the benefit associated with not implementing the policy is  $\nu$ . Thus, the net benefit of implementing the policy is  $\eta = \mu - \nu$  (excluding any compensation, which we return to later). We assume that this net benefit,  $\eta$ , is the private information of the government: the domestic firm does not know the specific value of  $\eta$ , but knows it is distributed uniformly on the interval  $[0, 1]$ .<sup>18</sup>

We use a parameter  $\rho \in [0, 1]$  to capture the quality of domestic property rights in the country. If the government implements a damaging policy, the domestic firm receives, and the government pays, compensation for the lost profits with probability  $\rho$ .

The domestic firm may form a partnership with a foreign firm by ceding a fraction  $f \in [0, 1]$  of its assets, and therefore profits, to a foreign partner (if  $f = 0$ , no partnership is formed).<sup>19</sup> The remainder,  $d = 1 - f$ , is retained by the domestic firm.

The effect of an investment agreement is captured by the probability that the foreign firms is compensated for damaging policies,  $\iota$ . Where domestic property rights are weak,  $\iota > \rho$ . The domestic firm expects to receive compensation equal to  $\rho\sigma rd$ ; it does not share into the compensation of  $\iota\sigma rf$  that the government expects to pay to the foreign firm.

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<sup>18</sup>We break up  $\eta$  in order to allow for separate costs and benefits. It is not crucial for the following whether the firm does not know  $\nu, \mu$ , or both. More generally, all results follow if we assume that  $\eta$  is distributed according to some known probability density function,  $g(\eta)$ , as long as in equilibrium  $g'(\eta^*) \leq 0$  (this is a sufficient condition; necessary conditions are defined below). The condition implies that larger values of  $\eta$  do not become increasingly more likely – put differently, a sufficient condition for our results is that extreme temptations to expropriate are increasingly rare (as is the case with commonly used distributions, such as the exponential distribution and in the right tail of a normal distribution).

<sup>19</sup>Imposing a lower bound, such as a ten per cent equity stake, would not alter the following results.

Table A.1 reports the payoffs for both the government and firm depending on the history of the game.

**Table A.1: Payoffs for Government and Domestic Firm**

	government implements policy	
	no	yes
Government	$v$	$\mu - \sigma r[\rho d + \iota f]$
Domestic firm	$rd$	$(1 - \sigma)rd + \rho \sigma rd$

## Equilibrium

The solution concept is Subgame Perfect Nash Equilibrium, which is appropriate for a sequential move game.<sup>20</sup> We proceed via backwards induction with the government's decision of whether to implement a damaging policy. The government implements the damaging policy if and only if:  $\mu - \sigma r[\rho(1 - f) + \iota f] \geq v$ . Recall that  $\eta = \mu - v$ . Taken together, we have the threshold,  $\eta^*$ , defined as

$$\eta^* \equiv \sigma r[\rho(1 - f) + \iota f]. \quad (\text{A.1})$$

If  $\eta < \eta^*$ , the government does not implement the damaging policy; if  $\eta \geq \eta^*$ , the government implements the policy. Note that  $\eta^*$  is guaranteed to be in the unit interval. Because  $\eta$  is distributed uniformly on the interval  $[0,1]$ , the firm believes that the government will not implement the policy with probability  $\eta^*$ , and that the government will implement the policy with probability  $1 - \eta^*$ . As  $\eta^*$  increases, the threshold for implementing the damaging policy increases, and the government is less likely to implement the policy.

The firm's expected utility may now be written as  $\eta^* r(1 - f) + (1 - \eta^*)[(1 - \sigma)r(1 - f) + \rho \sigma r(1 - f)]$ . In equilibrium, the domestic firm cedes a portion of its assets to a covered foreign firm if

$$\kappa \equiv \frac{(1 - \sigma) + \sigma \rho[1 + \sigma(1 - \rho)r]}{r \sigma^2(1 - \rho)(\iota - \rho)} < 1. \quad (\text{A.2})$$

As  $\kappa$  increases, the domestic firm becomes less likely to cede assets.

Let  $f^*$  be the equilibrium amount of foreign ownership. The firm selects  $f$  to maximize its utility, creating the first order condition

$$\frac{\partial \eta^*}{\partial f} [r \sigma(1 - f)(1 - \rho)] - r[\eta^* \sigma(1 - \rho) + 1 - \sigma(1 - \rho)] = 0, \quad (\text{A.3})$$

subject to the constraint that  $f \geq 0$ . Plugging in  $\eta^*$  and  $\frac{\partial \eta^*}{\partial f}$ <sup>21</sup> and solving for  $f$  provides the

<sup>20</sup>Because the government moves last (substantively, damaging policies can only be implemented after an investment is made), there is no updating by private actors.

<sup>21</sup> $\frac{\partial \eta^*}{\partial f} = r \sigma(\iota - \rho) > 0$ .

firm's equilibrium level of partnership as  $f^* = \max \left\{ 0, \frac{1}{2} - \frac{(1-\sigma)+\rho\sigma[1+\sigma(1-\rho)r]}{2r\sigma^2(1-\rho)(\iota-\rho)} \right\}$ .

In equilibrium, the government implements the damaging policy if  $\eta \geq \sigma r[\rho(1-f) + \iota f]$ , and does not implement the policy otherwise. The firm forms a partnership with foreign ownership share  $f^*$ , in anticipation of the government's decision.

## Lemmas and Propositions

**Lemma 1.** *For a given level of foreign ownership, the probability that the government implements a damaging policy decreases in domestic property rights.*

*Proof.* Take the derivative of  $\eta^*$  with respect to  $\rho$ ;  $\frac{\partial \eta^*}{\partial \rho} > 0$ . □

**Lemma 2.** *If the foreign firm is covered by an investment agreement, the probability that the government implements a damaging policy decreases in foreign ownership.*

*Proof.* Take the derivative of  $\eta^*$  with respect to  $f$ ;  $\frac{\partial \eta^*}{\partial f} = (1-\sigma)r(\iota-\rho) > 0$ , because for a covered foreign firm  $\iota > \rho$ . □

### Proposition 1

*Proof.* For  $\iota > \rho$ ,  $\frac{\partial \kappa}{\partial \rho} > 0$ . Hence, the condition for foreign ownership, condition (A.2), is more likely to hold as  $\rho$  decreases. □

### Proposition 2

*Proof.* For uncovered firms,  $\iota = \rho$ .<sup>22</sup> The threshold for expropriation is now,  $\eta^* \equiv \sigma r \rho$ , which is independent of  $f$ ; thus,  $\frac{\partial \eta^*}{\partial f} = 0$ . The first order condition for the firm is now  $-r[\eta^* \sigma(1-\rho) + 1 - \sigma(1-\rho)]$ , which is strictly less than zero, so the costs of ceding control always outweigh the benefits, and the domestic firm would not form a partnership. □

## Allowing for $\eta \sim G(\eta)$

Recall that  $\eta = \mu - \nu$  represents the government's net benefit of implementing the harmful policy. The net benefit is the private information of the government, but the firm knows it is distributed uniformly on the interval  $[0, 1]$ . Here we relax that assumption and instead assume that the domestic firm believes that the net benefit,  $\eta$ , is distributed according to some known cumulative distribution function,  $G(\eta)$  with support covering the unit interval and with associated probability density function,  $g(\eta) > 0$ .

The probability that the government implements the damaging policy is then,  $G(\eta^*)$ , where  $\eta^* = \sigma r[\rho(1-f) + \iota f]$ , as before. The firm's objective function is,

$$G(\eta^*)r(1-f) + (1-G(\eta^*))r[(1-\sigma)(1-f) + \rho\sigma(1-f)]. \quad (\text{A.4})$$

<sup>22</sup>It may even be true that  $\iota < \rho$  if the domestic firm is better able to avail themselves of domestic legal recourse.



The firm maximizes his utility with respect to  $f$ , the share of foreign ownership, to produce the following first order condition,

$$g(\eta^*)\sigma^2r(1-f)(\iota-\rho)(1-\rho)-G(\eta^*)-(1-G(\eta^*))\sigma(1-\rho)=0. \quad (\text{A.5})$$

and the following second order condition,

$$g'(\eta^*)\sigma^3r^2(1-f)(\iota-\rho)^2(1-\rho)-2g(\eta^*)\sigma^2r(\iota-\rho)(1-\rho). \quad (\text{A.6})$$

A sufficient, but not necessary, condition for the second order condition to be less than zero (and thus a unique maximum) is that  $g'(\eta^*) \leq 0$ . This holds if larger values of  $\eta$  become increasingly unlikely; this is consistent with the idea that expropriation is a relatively rare event. The sufficient condition holds for the uniform distribution because  $g' = 0$ . It also holds for common distributions such as the normal distribution in its right tail and for the exponential distribution.

The proofs of Lemmas 1 and 2 follow from the derivative of  $\eta^*$  as before. Because we cannot solve for  $f$  explicitly, the proof of Proposition 1 requires a different set-up.

*Proof.* Here we show that the equilibrium  $f$  is decreasing in  $\rho$ , and thus the threshold for foreign partnership is likely to be larger than zero when  $\rho$  is small. We use the implicit function theorem (IFT) to sign  $\frac{\partial f}{\partial \rho}$ . The numerator of the IFT is,

$$\frac{\partial f}{\partial \rho} = g'(\eta^*)\sigma^3r^2(\iota-\rho)(1-f)^2(1-\rho) - g(\eta^*)\sigma^2r(1-f)(2+i-3\rho) - (1-G(\eta^*))\sigma. \quad (\text{A.7})$$

A sufficient condition for the numerator to be negative is again that  $g'(\eta^*) \leq 0$ . The denominator is the second order condition, which is likewise negative when  $g'(\eta^*) \leq 0$ . The IFT then is negative overall, and  $f$  is decreasing in  $\rho$  (as long as  $g'(\eta^*) \leq 0$ ), which is what we wanted to show.  $\square$

## B Online appendix: empirical models

The following countries are included in the sample: Argentina, Azerbaijan, Bahrain, Bangladesh, Bolivia, Bulgaria, Cameroon, Congo, Costa Rica, Croatia, Dominican Republic, Ecuador, Egypt, Estonia, Georgia, Guatemala, Honduras, Jamaica, Jordan, Kazakhstan, Kyrgyz Republic, Latvia, Morocco, Mozambique, Nicaragua, Panama, Peru, Romania, Senegal, Slovak Republic, Sri Lanka, Trinidad and Tobago, Tunisia, Ukraine, Uruguay.

Tables B.1 and B.2 present summary statistics of our main variables. The remaining tables list several additional results. The main results reported in the paper are based on truncated zero-negative binomial models, which account for the truncated distribution of the dependent variable (which does not include zeros). Table B.3 instead reports the results from more common negative binomial regressions. The negative, statistically significant association between property rights and M&As remains. In Table B.4, we replicate the results from Table 1 in the main text, but recode the dependent variable to zero for country-years without an M&A reported, and estimate negative binomial models.

The main sample in the paper covers non-OECD countries with investment agreements with the United States. Most notably, this excludes Mexico from the sample, which is an OECD country; yet, Mexico is also a popular investment destination for U.S. firms, and Mexico is, unlike most other OECD countries, not a high-income country. In Table B.5, we therefore alternatively limit the sample to non-high-income countries. The results are substantively similar.

Table B.6 presents the results from several models to account for unobserved country heterogeneity. For column 1, we estimate a linear regression model with log M&As as the dependent variable; standard errors are, as before, clustered by country. To account for unobserved country heterogeneity, we estimate a random effects model, which assumes that any country-specific heterogeneity is uncorrelated with the included regressors. The coefficient estimate on domestic property rights hardly changes compared to a linear regression model without

random effects, and it remains negative and statistically significant. In column 2, we include country fixed effects. While the coefficient estimate retains its negative sign, it decreases in size and loses statistical significance at conventional levels. Finally, in column 3 we estimate a hierarchical linear model that allows for partial pooling (with standard errors still clustered by country). The model allows for both country-specific intercepts and country-specific effects of domestic property rights. The coefficient estimate on domestic property rights increases again in size and returns to statistical significance.

Table B.7 provides several additional results. The first column drops M&As that involve state-owned enterprises, which may be less subject to political risk than other firms (however, many of these state-owned enterprises are privatized through M&As, and from then on would potentially be subject to the same political risk as firms that are already privately owned). The second column drops M&As in which one hundred percent of the domestic firm were held by a U.S. firm after the acquisition. Note, however, that we lack data on the ownership share for a large number of M&As, which implies that the resulting dependent variable is likely overcounting the number of partial M&As (because we are undercounting the number of full M&As). The third column codes country-years without M&As reported to zero and presents results from a zero-inflated negative binomial model, where the inflation equation includes a constant and the property rights variable. Finally, the variable on domestic property rights is missing for the years 1997, 1999, and 2001, but available for 1996, 1998, 2000, and 2002. For most countries, the property rights variable is relatively stable over the period of a few years. We therefore fill in the missing data as the average of the neighboring years (i.e., we replace the missing value for 1997 with the country's average of 1996 and 1998) and re-estimate the main model from column 1, Table 1.

Table B.8 reports results when including a number of additional control variables. First, we include the share of natural resource production in GDP, obtained from the World Bank, to account for the structure of a country's economy; in particular, countries reliant on nat-

ural resources tend to have poorer institutional environments and, because natural resource extraction is often capital-intensive (and lucrative), tend to attract foreign investors. Second, we include a dummy variable for countries that are using the U.S. dollar as official currency (obtained from the Penn World Tables), which should facilitate investments for U.S. firms. We also include a variable for the exchange rate level, relative to the U.S. dollar (obtained from the Penn World Tables, column 3) and a variable for the exchange rate regime (obtained from the IMF classification of exchange rates, column 4). In column 5, we include a variable for IMF programs in place, given that one goal of IMF programs is the strengthening of the domestic institutional environment (in particular, the provision of property rights) and the attraction of international investments. In column 6, we account for economic dependence on the U.S. in the form of the overall direct investment position, and in column 7 we include a variable for political dependence in the form of military aid received from the U.S. as a percentage of GDP. The results are robust to the inclusion of these control variables.

Domestic property rights likely correlate with the development of the domestic financial sector and therefore the availability of credit to the private sector. Table B.9 includes several alternative control variables in place of the availability of domestic credit to account for the development of the domestic financial market: log stock market capitalization (column 1), the logged number of listed companies (column 2), the net interest rate margin of domestic banks (column 3), and the number of M&As between domestic firms. We obtain the first three variables from the Global Financial Development Database; the data on domestic M&A are compiled from Thomson One. The results are robust to the inclusion of these variables.

Figure 2 in the main text is based on a model that includes countries without U.S. investment agreements and interacts the variable for membership in investment agreements with the explanatory variables. The full results are reported in Table B.10.

Finally, additional evidence, mentioned in the text, based on ownership shares in M&A transactions and based on equity and bond issues by domestic firms is displayed in Table B.11.

**Table B.1: Summary statistics, M&A data**

Variable	Mean	Std. Dev.	Min.	Max.	N
M&As	4.448	8.000	1	65	192
Property rights	0.503	0.117	0.211	0.751	192
Democracy	0.703	0.458	0	1	192
GDP	24.266	1.118	21.391	27.133	192
GDP per capita	4.664	4.037	0.396	21.188	192
Population	16.16	1.18	13.494	18.763	192
Capital account	74.935	27.833	12.5	100	192
US distance	8.272	0.503	7.275	9.106	192
Domestic credit	3.372	.692	1.72	4.567	192
Year	2005.365	4.541	1996	2012	192

**Table B.2: Summary statistics, Equity and Bond data**

Variable	Mean	Std. Dev.	Min.	Max.	N
Equity and bond	16.544	28.255	1	201	193
Property rights	0.533	0.105	0.266	0.751	193
Democracy	0.622	0.486	0	1	193
GDP	24.36	1.073	21.222	27.133	193
GDP per capita	4.864	4.332	0.345	21.188	193
Population	16.221	1.238	13.494	18.791	193
Capital account	72.085	27.754	12.5	100	193
US distance	8.343	0.476	7.275	9.106	193
Domestic credit	3.54	.652	1.68	4.57	193
Year	2005.104	4.543	1996	2012	193

**Table B.3: Property rights and domestic-foreign partnerships, negative binomial**

	M&As between domestic and U.S. firms				
	(1)	(2)	(3)	(4)	(5)
Property rights	-1.96*** (.005)	-1.96*** (.002)	-1.87*** (.009)	-1.92*** (.004)	-1.38** (.010)
Democracy	.66*** (.000)	.72*** (.000)	.75*** (.000)	.65*** (.000)	.85*** (.000)
GDP	1.49*** (.000)	1.37*** (.000)	1.54*** (.000)	1.50*** (.000)	1.45*** (.000)
GDP per capita	-.12*** (.003)	-.13*** (.001)	-.13*** (.004)	-.12*** (.002)	-.14*** (.001)
Population	-.93*** (.000)	-.96*** (.000)	-.99*** (.000)	-.92*** (.000)	-.94*** (.000)
Capital account	.0037* (.078)	.0032 (.148)	.0030 (.177)	.0042 (.116)	.00092 (.717)
US distance	.44** (.024)	.74*** (.002)	.50** (.016)	.45** (.020)	.51* (.097)
Domestic credit	.054 (.628)	.085 (.368)	.090 (.376)	.080 (.500)	.084 (.517)
Bilateral trade openness		.18 (.142)			.11 (.434)
Economic complexity			-.13 (.388)		
US military aid				-.013 (.824)	
Statistical capacity					-.017 (.214)
Constant	-22.6*** (.000)	-24.2*** (.000)	-23.5*** (.000)	-22.9*** (.000)	-23.6*** (.000)
Year FE	yes	yes	yes	yes	yes
Number Obs.	192	188	189	189	125
Number Countries	33	33	32	33	29

Negative binomial regression, coefficient estimates and  $p$ -values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.

**Table B.4: Property rights and domestic-foreign partnerships, including country-years without M&As**

	M&As between domestic and U.S. firms				
	(1)	(2)	(3)	(4)	(5)
Property rights	-2.39*** (.006)	-2.29*** (.007)	-2.53*** (.003)	-2.57*** (.003)	-1.51** (.017)
Democracy	.89*** (.000)	.94*** (.000)	.75*** (.000)	1.03*** (.000)	1.09*** (.000)
GDP	2.06*** (.000)	1.96*** (.000)	1.90*** (.000)	2.03*** (.000)	1.87*** (.000)
GDP per capita	-.19*** (.000)	-.20*** (.000)	-.18*** (.001)	-.17*** (.000)	-.19*** (.000)
Population	-1.32*** (.000)	-1.37*** (.000)	-1.14*** (.000)	-1.36*** (.000)	-1.23*** (.000)
Capital account	.0095** (.011)	.0088** (.021)	.011*** (.003)	.0074** (.042)	.0055 (.105)
US distance	.55** (.021)	.80*** (.005)	.40* (.092)	.54** (.014)	.56* (.083)
Domestic credit	.12 (.398)	.12 (.391)	.023 (.872)	.10 (.477)	.24 (.125)
Bilateral trade openness		.16 (.201)			.23 (.169)
Economic complexity			.33* (.072)		
US military aid				.082 (.173)	
Statistical capacity					.0012 (.944)
Constant	-31.7*** (.000)	-33.1*** (.000)	-29.3*** (.000)	-31.5*** (.000)	-33.8*** (.000)
Year FE	yes	yes	yes	yes	yes
Number Obs.	340	326	324	334	212
Number Countries	37	37	34	37	33

Negative binomial regression, coefficient estimates and *p*-values. Missing values on the dependent variable coded as zero. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.

**Table B.5: Property rights and domestic-foreign partnerships, excluding high-income countries**

	M&As between domestic and U.S. firms				
	(1)	(2)	(3)	(4)	(5)
Property rights	-1.53** (.035)	-1.48** (.029)	-1.69** (.025)	-1.69** (.041)	-3.03*** (.002)
Democracy	.55*** (.005)	.55*** (.006)	.52** (.017)	.55*** (.002)	.93*** (.000)
GDP	1.19*** (.000)	1.12*** (.000)	1.13*** (.000)	1.18*** (.000)	1.16*** (.001)
GDP per capita	.027** (.047)	.031* (.089)	.033** (.048)	.028 (.244)	-.068 (.185)
Population	-.50*** (.004)	-.49*** (.006)	-.45** (.014)	-.47** (.012)	-.96*** (.003)
Capital account	-.0014 (.671)	-.0018 (.594)	-.00061 (.849)	-.00061 (.877)	-.00077 (.828)
US distance	-.27 (.155)	-.18 (.567)	-.26 (.175)	-.20 (.344)	.75** (.039)
Domestic credit	.33*** (.001)	.33*** (.002)	.32*** (.001)	.33*** (.001)	.39*** (.008)
Bilateral trade openness		.046 (.690)			.40*** (.005)
Economic complexity			.10 (.604)		
US military aid				-.018 (.736)	
Statistical capacity					.0069 (.468)
Constant	-17.6*** (.000)	-17.5*** (.000)	-17.1*** (.000)	-18.2*** (.000)	-24.8*** (.000)
Year FE	yes	yes	yes	yes	yes
Number Obs.	226	222	226	220	136
Number Countries	37	36	37	37	31

Truncated negative binomial regression, coefficient estimates and *p*-values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Non-high-income countries with U.S. BITs or trade agreements with investment chapters.



**Table B.6: Country-specific effects models**

	(1)	(2)	(3)
	RE	FE	HLM
Property rights	-1.68** (.015)	-.91 (.486)	-1.58*** (.006)
Democracy	.39*** (.000)	.14 (.301)	.45*** (.000)
GDP	1.00*** (.000)	.33 (.355)	1.00*** (.000)
GDP per capita	-.078*** (.004)	-.058 (.142)	-.078*** (.003)
Population	-.60*** (.000)	-1.59 (.195)	-.62*** (.000)
Capital account	.005** (.013)	.012*** (.002)	.004** (.021)
US distance	.41** (.015)	0 (.)	.50*** (.001)
Domestic credit	.061 (.599)	.17 (.360)	.033 (.754)
Constant	-16.5*** (.000)	17.5 (.281)	-16.8*** (.000)
Year FE	yes	yes	yes
Number Obs.	192	192	192
Number Countries	33	33	33

\*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%.  
 Non-OECD countries with U.S. BITs or trade agreements with investment chapters.

**Table B.7: Additional models**

	M&As between domestic and U.S. firms			
	(1)	(2)	(3)	(4)
Property rights	-1.64** (.022)	-2.16** (.010)	-2.66*** (.006)	-1.90** (.050)
Democracy	.65*** (.000)	.66*** (.000)	.88*** (.000)	.92*** (.000)
GDP	1.54*** (.000)	1.47*** (.000)	2.05*** (.000)	2.05*** (.000)
GDP per capita	-.13*** (.005)	-.14*** (.008)	-.19*** (.000)	-.21*** (.001)
Population	-.91*** (.000)	-1.00*** (.000)	-1.31*** (.000)	-1.31*** (.000)
Capital account	.0040* (.070)	.0032 (.222)	.0097*** (.006)	.0026 (.349)
US distance	.35* (.091)	.67*** (.001)	.56** (.021)	.34 (.210)
Dpmestic credit	.067 (.553)	.16 (.191)	.12 (.385)	.026 (.810)
Constant	-23.9*** (.000)	-23.4*** (.000)	-31.4*** (.000)	-29.3*** (.000)
Year FE	yes	yes	yes	yes
Number Obs.	192	192	340	227
Number Countries	33	33	37	33

Negative binomial regression, coefficient estimates and  $p$ -values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters. Column 1 drops M&As involving state-owned companies; column 2 drops M&As where the U.S. firm acquired a 100% ownership stake in the domestic firm. Column 3 estimates a zero-inflated negative binomial regression. Column 4 fills in missing values of the property rights variable with neighboring years.

**Table B.8: Property rights and M&As – additional control variables**

	M&As between domestic and U.S. firms						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Property rights	-1.60 (.129)	-2.34** (.020)	-2.50*** (.010)	-2.21** (.040)	-2.26** (.046)	-2.18* (.050)	-1.84** (.033)
Democracy	1.05*** (.000)	.89*** (.000)	1.01*** (.000)	.94*** (.000)	1.00*** (.000)	.99*** (.000)	.92*** (.000)
GDP	2.13*** (.000)	2.16*** (.000)	2.36*** (.000)	2.54*** (.000)	2.36*** (.000)	2.25*** (.000)	2.26*** (.000)
GDP per capita	-.22*** (.001)	-.22*** (.002)	-.27*** (.002)	-.33*** (.000)	-.27*** (.002)	-.25*** (.001)	-.21*** (.001)
Natural resources	.099 (.279)						
Population	-1.40*** (.000)	-1.43*** (.000)	-1.61*** (.000)	-1.77*** (.000)	-1.62*** (.000)	-1.54*** (.000)	-1.31*** (.000)
Capital account	.0023 (.447)	.0046 (.148)	.0040 (.256)	.0035 (.326)	.0027 (.451)	.0023 (.505)	.0036 (.151)
Domestic credit	.21 (.215)	.15 (.241)	.22 (.118)	.20* (.091)	.22 (.222)	.27 (.160)	.21* (.075)
US distance	.38 (.223)	.45 (.144)	.62* (.054)	.54 (.110)	.59* (.072)	.56 (.117)	.34 (.226)
Currency U.S. dollar		-.33 (.157)					
Exchange rate level			.00062 (.325)				
Fixed exchange rate				.060 (.760)			
IMF program					.020 (.938)		
US investment						.000 (.886)	
US military aid/GDP							.43** (.022)
Constant	-30.8*** (.000)	-31.2*** (.000)	-34.6*** (.000)	-35.3*** (.000)	-33.8*** (.000)	-32.4*** (.000)	-35.4*** (.000)
Year FE	yes	yes	yes	yes	yes	yes	yes
Number Obs.	184	192	174	157	168	154	189
Number Countries	32	33	31	32	31	31	33

Truncated negative binomial regression, coefficient estimates and *p*-values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.

**Table B.9: Domestic financial market development**

	M&As between domestic and U.S. firms			
	(1)	(2)	(3)	(4)
Property rights	-2.02** (.018)	-1.63** (.045)	-1.73** (.034)	-1.47** (.048)
Democracy	1.16*** (.000)	1.01*** (.000)	1.12*** (.000)	.72*** (.000)
GDP	2.19*** (.000)	2.01*** (.000)	1.99*** (.000)	1.86*** (.000)
GDP per capita	-.27*** (.003)	-.21*** (.000)	-.22*** (.000)	-.18*** (.003)
Population	-1.43*** (.000)	-1.30*** (.000)	-1.27*** (.000)	-1.21*** (.000)
Capital account	.0054 (.118)	.0067** (.036)	.0033 (.240)	.0042 (.181)
US distance	.34 (.388)	.26 (.418)	.30 (.280)	.16 (.580)
Stock market capitalization	.13* (.055)			
Number listed companies		-.15 (.161)		
Net interest margin			-.072** (.039)	
Domestic M&As				.0054*** (.004)
Constant	-31.0*** (.000)	-28.2*** (.000)	-28.0*** (.000)	-25.0*** (.000)
Year FE	yes	yes	yes	yes
Number Obs.	148	162	184	192
Number Countries	25	25	33	33

Zero-truncated negative binomial regression, coefficient estimates and *p*-values. Standard errors clustered by country. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.

**Table B.10: Interaction with U.S. investment agreements**

	(1)	(2)	(3)
Property rights	2.34*** (.001)	2.13*** (.002)	2.14*** (.000)
x investment agreement	-4.04*** (.000)	-3.83*** (.000)	-3.53*** (.000)
Capital account	.0091** (.031)	.0090** (.029)	.012*** (.005)
x investment agreement	-.0052 (.254)	-.0059 (.192)	-.0081* (.095)
Democracy	.49** (.010)	.53*** (.005)	.49*** (.000)
x investment agreement	.41* (.095)	.43* (.095)	.46* (.068)
GDP	.55*** (.000)	.46*** (.004)	.42*** (.001)
x investment agreement	1.53*** (.000)	1.45*** (.000)	1.62*** (.000)
GDP per capita	.035 (.107)	.032 (.131)	.018 (.301)
x investment agreement	-.24*** (.000)	-.24*** (.000)	-.24*** (.000)
Population	.47*** (.001)	.46*** (.002)	.55*** (.000)
x investment agreement	-1.80*** (.000)	-1.80*** (.000)	-1.84*** (.000)
US distance	-.56*** (.005)	-.55*** (.009)	-.66*** (.000)
x investment agreement	.92** (.012)	1.26*** (.005)	1.04*** (.003)
Domestic credit	.35** (.026)	.32** (.031)	.32*** (.006)
x investment agreement	-.18 (.354)	-.13 (.469)	-.21 (.188)
Bilateral trade openness		.15 (.106)	
x investment agreement		.036 (.846)	
Economic complexity			.55***

**Table B.11: Additional evidence: foreign ownership shares & bond and equity issues**

	Foreign ownership share			Bond and equity issues		
	(1)	(2)	(3)	(4)	(5)	(6)
Property rights	-2.40** (.013)	-2.35** (.021)	-2.21** (.034)	-4.25*** (.009)	-3.93** (.014)	-4.24** (.011)
Democracy	-.15 (.499)	-.19 (.419)	-.024 (.934)	.11 (.754)	.13 (.667)	.38 (.329)
GDP	.46 (.148)	.58 (.113)	.47 (.148)	1.59*** (.000)	1.14*** (.007)	1.75*** (.000)
GDP per capita	-.090 (.240)	-.090 (.237)	-.098 (.214)	-.18** (.016)	-.16** (.013)	-.20*** (.002)
Population	-.47 (.149)	-.48 (.158)	-.52 (.114)	-.99*** (.006)	-.94** (.017)	-1.27*** (.000)
Capital account	.006** (.022)	.007** (.020)	.005* (.065)	.015*** (.007)	.010* (.066)	.015** (.011)
US distance	-.17 (.561)	-.40 (.244)	-.028 (.930)	1.39*** (.001)	1.87*** (.000)	1.73*** (.000)
Domestic credit	-.17 (.179)	-.18 (.131)	-.12 (.364)	.49 (.137)	.51* (.072)	.43 (.150)
Bilateral trade openness		-.11 (.459)			.50*** (.005)	
Economic complexity			-.22 (.257)			-.47 (.102)
Shareholder protections				.087 (.515)	.022 (.870)	-.003 (.984)
Constant	-.55 (.863)	-.074 (.982)	-1.56 (.615)	-31.7*** (.000)	-32.4*** (.000)	-33.3*** (.000)
Year FE	yes	yes	yes	yes	yes	yes
Number Obs.	258	256	258	177	174	175
Number Countries	29	27	29	28	27	27

Columns (1)-(3): Beta regression, coefficient estimates and *p*-values. Standard errors clustered by country. Dependent variable: Ownership share acquired by foreign firm in M&A transaction. Columns (4)-(6): Truncated negative binomial regression, coefficient estimates and *p*-values. Standard errors clustered by country. Dependent variable: Bond and equity issues by domestic firms. \*\*\* significant at 1%, \*\* significant at 5%, \* significant at 10%. Countries with U.S. BITs or trade agreements with investment chapters.